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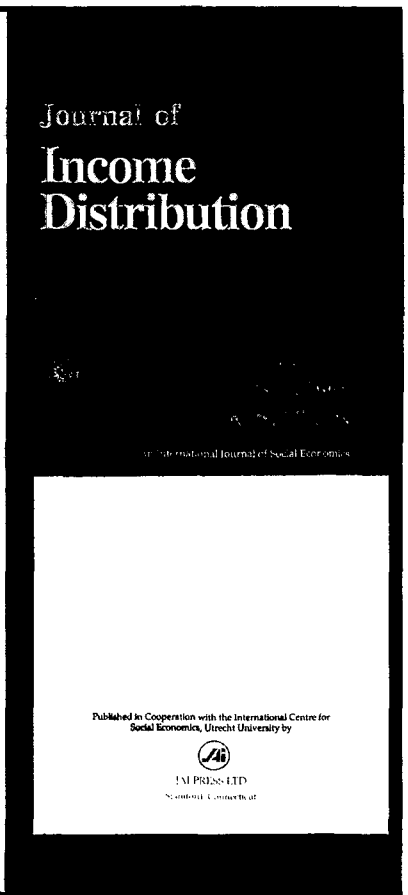
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FINANCIAL CYCLES, BUSINESS ACTIVITY, AND THE STOCK MARKET

ANTONY P. MUELLER

The monetary theory of the business cycle in the tradition of Austrian economics[1] holds that trade cycles result from excessive growth of circulating credit, which affects the real economy, leading to unsustainable investment projects that get corrected in a recession when credit contraction occurs. Government and monetary authorities who systematically practice a policy of stabilizing financial assets and business activities by a policy of easy money and bailouts expose individual economic agents to a learning process of diminishing risk perception. Moral hazard as its consequence brings forth more credit growth. While, in the short run at least, these policies may stimulate economic activity, they put the economy on a path to more malinvestment in the long run. With governments and monetary authorities providing tight safety nets, a hideous form of central planning is being installed, causing the spread of soft-budget constraints and the misallocation of capital. Unhampered credit growth as the result of such measures puts the economy on a path toward overextension of investment and consumption patterns that get out of line with individual time preferences and the availability of specific resources. If it were only a matter of aggregate demand and supply gaps, the application of expansive and restrictive measures might cure the problem when the disequilibria become more manifest. But it is under the expectation of ample availability of funds that investors and consumers have pursued a pattern of demand that has become incompatible with sustainable funding in real terms. Economic booms based on credit expansion appear as a period in which, for some time, the law of scarcity seems nonexistent and economic agents tend to pursue projects for which the economy is not yet rich

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[1]For an overview, see Ebeling (1996).

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enough. In this view, the onset of a recession signals the need for structural adaptation at the micro-level, and not the mere readjustment of aggregates.

In this article, the prime concepts are based on the Mises-Hayek theory of the business cycle. Using this model as the general framework for analysis, additions and modifications are introduced reflecting theoretical advances and current problems.

MONEY AND THE BUSINESS CYCLE

Austrian economics uses a micro-foundation for monetary theory and stresses that economic phenomena must be explained on the basis of individual human action.[2] According to Mises (1940, 1980, 1998), the "originary rate of interest" is based on the subjective-individualist valuation of time preference. This rate of interest reflects the discount (rate) of future goods to present goods. The originary rate of interest is based on human valuation, and as such, it is not a monetary phenomenon. It also cannot be explained in the classical mold by the productivity of capital or by the demand and supply of funds. The originary interest rate as a praxeological category reflects the time preference between first order and second order goods, or between consumption and production goods, and in turn constitutes the division of human activity between them. The fact that capital goods are used in the production of consumption goods explains their price but not the interest rate. The originary interest rate is not dependent on the supply of savings, but instead determines the degree of division of goods along the time periods, as consumer time preferences are manifest in terms of demand and supply of savings. If, for example, care for the future should stop as the result of some "end-of-time" syndrome, capital goods would lose their value, and the rate of interest would tend to rise toward infinity irrespective of the money supply made available by a central bank. On the other hand, a hypothetical originary interest of zero would imply the cessation of present consumption, and activities would exclusively be directed toward the production of capital goods.

The central thesis of Mises's monetary theory consists in the proposition that the monetary rate of interest may deviate from the neutral and the originary rate of interest due to money creation (or its contraction) in the credit markets.[3] By using sequential analysis in contrast to the "all-at-once adaptation" as

[2]For a systematic exposition see Rothbard (1997).

[3]A somewhat different starting point is given by Hayek (1941) as his theory also contains elements of the "real business cycle," making his approach in this regard "un-Austrian"; for Mises, in contrast, the central point is prolonged growth of credit creation beyond mere intermediation; this extension of circulating credit may also be the result of reduced risk perception, when government or central bank bailout guarantees are presumed to exist.

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implied by the quantity theory of money, Mises points out that money and credit cannot be neutral, because they do not affect the economy in the same quantities for all economic agents at the same time. While changes of money in circulation may or may not change the price level, aggregate changes imply that relative prices, and with them the relative positions of the individual economic agents, will change. Money and credit enter the economy in a specific form and affect the rest of economic actors in different ways.[4] Only perfect foresight could transform the monetary rate of interest into a neutral rate by applying a price premium. But the formation of expectations about a certain direction of prices is disparate and must remain uncertain.

The Misesian theory of the business cycle holds that the extension of circulating credit implies the transformation of the capital structure by way of changing relative prices and that the boom and bust of credit creation is reflected in real economic activity. When easy money continues to feed the boom, the time-horizon of investment projects gets larger, but when the pace of credit creation diminishes and turns into credit contraction, various economic plans must be abandoned. The onset of a recessionary reshifting process can sometimes be interrupted when new liquidity injection allows the continuation of the old plans. While Keynesian analysis argues that a new upswing based on the multiplier effect will occur, the Mises-Hayek model leads to the conclusion that the new liquidity, while inciting business activity, will make economic distortions more severe. Whereas, at the micro-level, the economy is in need of readaptation, macro-policies prevent this process from taking place, thus inducing an even more severe downturn or a prolonged slump later on. This becomes almost unavoidable after a series of bailouts and injections. When, as it is necessarily the case, bailouts and liquidity creation go hand in hand, this artificial boom will almost inevitably result in a bust that finally becomes immune to further liquidity and direct-demand impulses. Monetary wealth has created an illusion of prosperity and in its wake the structure of the economy has shifted toward consumption and investment patterns that would be in line only with a much higher level of real wealth. But because the real wealth of the economy could not be increased by the mere enlargement of the money stock or rising velocity, the expansion of credit brings about imbalances within the economy, which later require reversals brought about by a recession. Despite the increase in monetary wealth during the boom period, as is reflected in rising valuations of real estate or stocks as

[4]Even if the change in the quantity of money could be known in time, and if it were known for which kind of activities it enters the economy, it is impossible to know ex ante how this will affect the different prices. It is impossible to foresee how, when and to what degree individual valuations will change, and it is individual valuations, not macroeconomic aggregates, that determine the specificity of economic actions.

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an expression that capital is being perceived to have become more valuable relative to money, credit expansion will have diminished real wealth during this phase when the credit-induced projects represent erroneous and unsustainable investment.

CAPITALIST CALCULATION

Modern financial market theory excludes the possibility that, for some prolonged time, investors may be induced to pursue erroneous activities. But equilibrium in terms of information efficiency may not arise because knowledge in society is unevenly distributed and different agents hold deviant and often contradictory theories, which may generate diverse expectations.[5] On the other hand, misinformation must not necessarily be randomly distributed but is systematic, when the money rate of interest conveys erroneous expectations about the availability of real funds. Then, monetary effects are not limited to the general price level, but they fundamentally disrupt equilibrium relations and lead to a mispricing of assets.

Government intervention and policy-guided credit allocation exacerbate the effects of easy money as they lead to moral hazard and induce soft budgets. For some time, the disturbances may remain unnoticed based on the observation of the price level, as the index does not contain information about relative prices. Relative inflation (Haberler 1996, p. 37) may occur–and remain unnoticed in average prices as well–when new products and productivity growth emerge on a larger scale.[6] Monetary policy is led to maintain an erroneous monetary rate of interest and cause a further deepening of the capital structure, which in turn tends to generate higher productivity growth and innovation in specific sectors of the economy, although this will contribute further to false interpretations of the state of the economy, because average productivity growth rates contain misleading information when they result from efficiencies that are concentrated in those sectors of the economy where malinvestments happen.

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[5]For early discussions of these problems see, Lachmann (1943, pp. 12-23) and Mises, (1943, pp. 251); for a modern Austrian exposition, see O'Driscoll and Rizzo (1985).

[6]Given present circumstances with the status attached to statistical data, it has also become more frequent that "creative accounting" is not limited to companies that pursue "shareholder value," but is also done by governments when price indexes are reformulated. The newly applied "hedonic price index formula" by the U.S. Bureau of Labor Statistics, for example, does not only reduce average inflation rates, it also provides a statistical boost to productivity and investment expenditures, which then get registered as higher real growth rates in GDP calculations. While both procedures are deceiving, the U.S. method is smarter than the Japanese practice during the boom period of the 1980s, when obsolete items in the basket were removed with considerable time lags, thus artificially stabilizing the price index.

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The assumption of rational behavior is an essential starting point in economic theory. But when models of direct exchange are used, the analysis misses the specific character of rationality in capitalist calculation, which is closely tied to monetary values. When analyzing the economy in terms of short-run static equilibrium, the application of modeling techniques is facilitated, but the results are not necessarily in tune with the demands of reality. Capitalist calculation in a monetary economy must use monetary expressions as an instrument of planning economic action, both for consumers and investors. It is money and markets that allow rational calculation, and markets are structured by calculation in monetary terms. For Mises (1940, p. 204), economic calculation beyond a market economy lacks foundation and becomes a senseless effort. Economic calculation in the form of accounting as it was developed with the rise of modern capitalism constitutes the most important instrument of rationality for guiding economic decisions and actions. It is intimately tied to monetary valuations, and in order to be meaningful, it must be based on a price-system that has private property and open markets at its foundation.[7] Central planning and government intervention falsify monetary calculation, which is also deprived of its rationality when the overall money supply and the interest rate become subject to public policies that use money and the interest rate as a means to achieve specific macroeconomic goals, such as a certain growth rate or a certain level of employment.

For the individual actor in the modern economy, monetary valuations are the essential instrument for the rational formulation of economic plans. But money works as a destabilizing force if the monetary rate of interest no longer reflects adequately the relative valuation between current and future goods.[8] Besides excessive credit growth, deviations are caused by persistent current account imbalances, repeated bailouts, moral hazard, and specific government interventions that hamper the free movement of prices and undermine the internalization of losses and profits. For entrepreneurs, there are almost always more efficient technologies available than are presently in use, that is, almost any production process could be made newer and better,

[7]This is the central insight of the Austrian position in the socialist calculation debate (Hayek 1935) first put forth by Mises in 1922 (1981).

[8]Confusion has become popular due to the position of Keynes who put the Austrian concept of the "originary" and "neutral" rate of interest into the same pot as the Wicksellian concept of the "natural rate of interest," which refers to the general price level as the major indicator of equilibrium and disequilibria. In contrast to an analysis in terms of averages and aggregates, Hayek (1931) stresses that even a "natural rate of interest," in the sense that price stability is maintained, may cause profound disequilibria when credit causes shifts between the production and consumption of particular groups of goods. See Keynes (1973, pp. 183 and 242; see also chap. 22, p. 313), and Wicksell (1898) along with Hayek (1931).

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i.e., more productive. And for consumers, there are almost always consumption goods on the horizon that seem more attractive if personal wealth were higher. It is the risk of bankruptcy that limits the unrestrained pursuit of these goals, whereas loose monetary and credit conditions lower the degree of risk perception that a business venture will fail or that the individual consumer will miscalculate the permanence of his wealth. Easy credit conditions produce the expectation that there is an escape from the scarcity of time and resources, and that inhibits the application of the most productive ways in the production process and limits the consumption of superior goods.

STABILIZATION POLICIES AND SYSTEMIC FRAGILITY

While the prime thesis of modern finance theory—that financial markets are efficient—has gained more adherents, and while stabilization policies have been expanded on a global level to encompass emergent economies, financial markets have become more erratic and the swings of real economic activity have become more pronounced. Particularly since the mid-1990s, moral hazard, herding, and contagion have reached new dimensions in a series of financial crises and extreme stock market and currency movements.[9] Although criticism of the current stabilization paradigm is on the rise, particularly since the Asian crisis (for example, Eichengreen 1999), the major international financial organizations, with active support by national governments, have continued the policy of bailing out countries and financial institutions. Providing new liquidity and instigating more credit expansion have almost become matters of routine. But in contrast to the declared intention to stabilize economies, systemic fragility is on the rise (Davis 1995), as each new intervention provides the basis for the next crisis case—a feature that appeared prominently after the Mexican bailout of 1995.[10]

Programs by the International Monetary Fund, which originally were intended to restore confidence, now seem to serve as a signal to reverse capital inflows. While the bodies that form the international financial architecture are in search of leading indicators for early warning indicators of imminent financial crises, it is more so the IMF itself that provides these in a paradoxical way. For speculators in international financial markets, it has become an almost sure bet that after the announcement of a stabilization program and

[9]For data and analysis including the volatility of currencies, stock markets, international capital flows and spreads, see Bank for International Settlements (1999 and 2000).

[10]The apparent success of the Mexican bailout served as a trigger signal for the massive flow of new funds to emerging economies and to Asia in particular, and it may also have marked the watershed between cautious domestic stock investing and the phase that was characterized as "irrational exuberance" by Greenspan (1996) later on.

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the provision of new funds, the recipient country will enter into a financial crisis soon thereafter.[11]

The predominant form of current economic analysis, with its almost exclusive concentration on macro figures and a policy orientation toward stabilization, is negligent of the distortions these policies produce on the micro-level and of the changes of perceptions among the private agents that they induce. The readiness of monetary authorities, most notably in Japan and the United States, to provide ample liquidity in conjunction with the provision of so-called rescue packages to a series of emerging economies has led to the dramatic trade-off: While a stop of these measures would reveal the distortions immediately, the preference has shifted toward the continuation of the policy as long as new liquidity and further credit expansion may be expected to do their job.

Simplified macroeconomic concepts in the Keynesian tradition support these policies. Emphasizing the view that governments and public institutions are needed in order to stabilize markets, the IMF has assumed the role of a global economic policy authority. But with the interventionist spiral in full swing, its policy prescriptions begin to work counter to intentions. By ignoring the fact that monetary and fiscal impulses change relative prices and the capital structure of an economy, the policy formulations based on the analysis of aggregates miss the effects that take place at the micro-level and emerge as macroeconomic disequilibria only later on. Deceived by the experience that fiscal and monetary impulses quite often are highly effective in the early stages of a cycle, the rationale has become widely accepted that they would also work in the long run. But when measures to "keep the boom going" are applied repeatedly, more profound transformations of the capital structure will occur. This will make the economy less and less efficient, leading to a bust and, finally, to economic paralysis. For Austrian economics, the emergence of a recession signals a misdirection of investment due to discoordinated economic plans that need correction. Plans and economic actions must undergo revision in order to establish a new tendency toward equilibrium. But with new liquidity or active demand management, the process of reassessment and correction gets postponed, and the trend toward a widening of disequilibria is made to continue.

Systemic fragility is a situation where expectations of investors and consumers have become highly unstable and economic action is hampered by the perception of insecurity. This state of low confidence is brought about by policies that undermine the trust in the perceived validity of prices and the monetary interest rate as the basis of economic calculation. Systemic fragility

[11]Turkey, in 2001, is only the latest case of this kind in a series comprising a number of Asian economies, Russia, Brazil, and Argentina, among others.

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tends to show up at first in financial markets, because it is here where expectations and actions are most closely linked.[12] Once established and extended to the real economy, systemic fragility implies a process where monetary and fiscal instruments become less and less effective, and their application will only add to a deepening of the misalignments.

BUBBLE ECONOMIES

In a stylized sequential analysis, an artificial boom is initiated when monetary expansion is accompanied by the implicit or explicit promise of bailouts, opening the way toward excessive growth of circulating credit, i.e., money creation, which is not backed by the increase of real funds in terms of current savings. As commercial banks and other financial institutions become less risk-averse, investors are led to presume that the signaling and sanctioning effect of losses has become less important or is absent, and that will induce businesses to adopt more advanced standards of technology and to expand investment. Rising price-earnings ratios for shares signal stock market valuations, which imply an extension of the time horizon for investment that is incompatible with actual savings. Fundamental scarcity gets neglected in favor of expectations about future wealth that seem justified by the appearance of new areas of commerce, technological breakthroughs, income growth, and full employment. But the increased nominal wealth embodied in rising asset valuations induces not just a wealth effect but also a change in the pattern of consumption and production. Goods, that earlier seemed out of reach, now enter the demand schedule. Production and consumption are not only higher in nominal and price-deflated terms, but their structural composition changes as well. It is not just the demand for goods, that earlier were regarded as luxuries that is on the increase; science, research, and development also get impulses.[13] A spirit of prosperity enters all aspects of social and economic life.

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[12]In a tradition going back to Mackay (1841), reinforced by Keynes (1936, chap. 12), and recently presented by Chancellor (1999) and Shiller (2000), "psychological explanations" for financial turmoil are popularized. But concepts like "madness," "animal spirits," or "irrational exuberance" do not elucidate the economic and monetary causes for such states to emerge and rather leave us at despair or, in a hideous twist, suggest the conclusion "that the duty of ordering the current volume of investment cannot safely be left in private hands" (Keynes 1936, p. 320), obscuring even more so the role of governments and monetary authorities as the propagators of this kind of conditions in the first place.

[13]The perceived equilibrium position changes due to the expectation of future wealth. In this way investment activities get directed toward the "earlier stages of the production process," which under modern conditions are research and development, while consumption shifts to leisure products and other superior goods. But besides the limits set by the sustainable availability of real funds, it is time that puts a strict bound on the extension of such activities. For example, the projections of the growth of the new economy, and

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Bubble economies are being formed in a sequential manner, and their development cannot be grasped without taking duration into explicit consideration (O'Driscoll and Rizzo 1996, p. 198). The formation of a bubble economy is linked to a learning process and its stages are bound together by causal links where, at first, the expansion of circulating credit leads to an unsustainable pattern of demand, and that, in turn, is reflected in the corresponding production structure that absorbs resources beyond their long-term availability. The appearance of the imbalances is a process in time, as the incompatibilities do not show up right away but appear only later on, when finally complementary investment is lacking and ongoing investment projects must remain uncompleted, or when completed investment projects lay idle with inventories piling up. Demand for consumer and investment goods must undergo a phase of adaptation, as the need emerges for more urgent goods, which are not being produced in sufficient quantities, because their provision has been neglected in favor of the production of goods for which the economy is not yet wealthy enough. The expansion of credit induces the pursuit of economic goals that are incompatible with available means. Superficially, the appearance of unused capital and labor may be interpreted as a lack of demand, and additional liquidity will help to stimulate the economy in the short run; but while some older projects get completed and underutilization of production factors seems to disappear, new malinvestments are being initiated as well. It is almost inevitable that with the extension of the artificial boom, economic distortions will become more severe.

Among the large economies, it has been Japan in the past two decades that has fallen victim to this policy in both parts of the cycle. At first fabricating an extended upswing in the 1980s based on "low capital costs," government and monetary authorities have applied a host of interventionist schemes, ranging from direct bailouts to various fiscal measures and a monetary policy of low interest rates aimed at stimulating the economy, since the beginning of the recession, only to enhance government indebtedness with no recovery.[14]

But in the U.S., too, during the late 1990s, when unlimited prosperity seemed feasible based on intelligent monetary management, the boom became overextended when, partly induced by the international and domestic

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the Internet in particular, imply an extension that seems only realizable if consumers were so rich as to be able to increase future income along with a substitution of work for more leisure time.

[14]In Japan, the overnight call money rate has been brought down to effectively zero in 1999 and fiscal deficits have continued to rise, bringing the Japanese gross debt-GDP ratio up to over 100 percent, and the net debt-GDP ratio, which was 4 percent in 1992, up to over 30 percent of gross domestic product In 1999, the general government financial deficit exceeded 7 percent with a tendency to rise further in the coming years (BIS 1999, p. 18; 2000, pp. 20, 68).

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financial environment or special circumstances (such as the expectation of a "year 2000 problem"), monetary policy provided ample liquidity. This left aside the consideration of disequilibria in the economy that showed up more drastically each year during the second half of the 1990s, ranging from current account deficits and the accumulation of foreign debt to falling personal savings rates and rising domestic debt levels. While the deficit reduction of the central government was widely noticed, the unprecedented debt inflation in the other parts of the U.S. economy hardly attracted attention–despite the speed of its accumulation and its dimension.[15]

As long as it seemed that financial wealth creation by the stock markets could go on indefinitely, disequilibria hardly mattered, as the economy appeared to have access to sufficient funding in order to compensate for the lack of savings and rising internal and external debt levels. But as soon as asset valuations began to adjust, various additional disequilibria showed up with excess capacities in some areas and shortages in other sectors. Along with a sharp reversal of sentiment that accompanies the process of reassessment, the very factors whose interaction brought about the boom then start to work in reverse.

FINANCIAL MARKETS

Modern financial market theory assumes that deviations from equilibrium are largely a short-term phenomenon and that persistent disequilibria will not occur. When risk models are based on the concepts of information efficiency, the problem arises that, by ignoring the potential for long-term disequilibria, practitioners in financial markets are misled into taking excessive risk positions, thus making boom-and-bust cycles more severe.[16] The assumption of

[15]In the United States, the debt-income ratio of the household sector rose to over 100 percent of disposable income toward the end of the decade (BIS 1999, p. 19); the corporate sector experienced a sharp rise in debt, and although the profit situation remained favorable, corporate indebtedness increased to its highest level since 1990, with 80 percent of gross debt as a percentage of GDP in the corporate sector (p. 18). With the current account deficit of the U.S. reaching $338.9 billion in 1999 (BIS 2000, p. 32), debt issuance by the private sector accelerated drastically in the second half of 1990s and reached new highs every year in the second half of the 1990s, with an annual issue of $250 billion in 1994 and markedly over $1 trillion in 1999. Although the central government reduced slightly its debt position, independent public agencies and so-called "quasi-public" entities expanded their debt, so that the overall annual debt issuance of the total public sector more than doubled since the mid-1990s. In 1999, new private and public net debt issuance together amounted to more than $2,000 billion (p. 111); these figures drastically exceed both money and GDP growth.

[16]This is also acknowledged by the Bank for International Settlements in its 69th Annual Report (1999, p. 101), as it writes: "Risk management systems that have been primarily designed to measure and control market risk are not always appropriate to characterize price behavior. Such systems may actually contribute to the strain as they imply that

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market efficiency eliminates the need of judgment and implies that any asset price seems correct. But while prices are the most important instrument of obtaining economic information, this does not mean that prices contain all relevant information.[17] By ignoring fundamental uncertainty, the essence of financial and economic decision-making is discarded in favor of the simplified concept of risk. On a practical policy and management level, the risk models of modern finance contribute to a narrow understanding of financial markets, as the assumption prevails that in finance and economics there are constants or averages which may form the basis for mechanical calculations that hold in the future. This way, the importance of human action–that is, the creative formation of plans and their precarious transformation into action–gets lost in favor of a view that presumes normal conditions but is at disarray when dealing with exceptional circumstances.[18]

Economic and stock-market bubbles go hand in hand. They are produced by a monetary policy that manipulates the monetary interest rate in order to achieve higher economic growth or full employment targets, or which, by pursuing the more subtle forms of promising financial safety nets, implicitly creates moral hazard. By creating an economic and financial environment where profit and loss no longer seem to matter very much because bailout expectations have become manifest–be it in the form of monetary and fiscal policies or by way of specific bailouts–investment projects get overextended while personal savings contract. As the perception of risk recedes and capital valuations rise, it is only natural that the need to forego current consumption is seen to diminish.

Economic activity is a continual process of speculation, creation, and correction. It is this ongoing correction process that stabilizes a market economy. But in order for this process to work smoothly, free prices and the strict internalization of profits and losses are required. While individual errors are quite common and may largely explain short-term fluctuations, long-term deviations from equilibrium that end in an overall collapse of economic activity are a collective phenomenon characterized by a "mammoth cluster of errors" (Rothbard 1996, p. 73), and it might appear as if markets fail in coordinating economic activities. But neither the emergence of a bubble nor its breakdown

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investors should scale down portfolio risk by liquidating their positions in a declining market."

[17]Fund investing contributes further to produce excessive valuations in both parts of the cycle when the fund managers neglect valuations in favor of benchmarking and individual fund investors act solely on the basis of the fund's performance.

[18]The relentless application of modern finance theory by the Long-Term Capital Management Fund (LTCM) in its pursuit to bank on normal distributions is just one of the more dramatic recent illustrations of this point. See Lowenstein (2000).

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implies market failure; boom-and-bust cycles rest on policies that have destroyed the proper market process by explicit or implicit bailout guarantees and easy money.[19] When stock-market investors, creditors, and businessmen feel that there is no risk in overextending themselves, unrestrained financial and real investment becomes a competitive necessity. Bailout expectations shift the risk pattern. While before, the major risk of business expansion was the accumulation of excessive levels of debt, the orientation in an industry protected by bailouts is directed toward the problem of being left behind, should the expansion not be swift enough. Although direct bailouts of specific companies are mostly confined to economies with a weak market system, the protection of the financial sector is quite common, in developed and developing countries alike; but the effects are almost the same as with direct protection when, as its consequence, financial institutions feel safe to fulfill the demands for more dubious loans.[20] When monetary authorities repeatedly act to ward off economic downturns and continue to feed the markets with fresh liquidity, the belief in an eternal boom becomes more widespread each time, and economic activity becomes more intensive. With the continuation of such a boom, prudence diminishes, and new types of entrepreneurs appear, who neglect profits in favor of market share and who eagerly apply the latest standards of technology irrespective of a prudent evaluation of their economic merits. Such a state is characterized by general optimism, the basis of which is found in the continuance of interacting feedback between expectation and verification among the actions of consumers, shareholders, businessmen, government, and monetary authorities.[21]

Asset bubbles need a threefold basis: first, there must be a monetary policy that allows excessive credit growth; second, monetary authorities and the government must induce moral hazard by signaling their readiness for

[19]Historically, "Law's System" is the prototype, where, like in its follow up, the "South Sea Bubble," credit creation and direct government involvement operated closely together. For a historical overview, see Kindleberger (1989).

[20]In order to produce the boom, the central bank and the financial sector must work in tandem, while the symbiosis breaks down in the bust-phase when banks are forced into a credit crunch because of the burden of nonperforming loans on their books.

[21]While Keynes (1936, pp. 315ff.) vividly describes the emotional state of affairs as he came to see it during the 1920s, when financial markets "under the influence of purchasers largely ignorant of what they are buying and of speculators who are more concerned with forecasting the next shift of market sentiment than with a reasonable estimate of the future yield of capital assets" became exposed to sudden shifts of sentiments, he pays little attention to the underlying monetary factors for this state of affairs in this specific period (cf. Rothbard 1983) and regards the "sudden collapse in the marginal efficiency of capital" as a "highly psychological phenomenon" (Keynes 1936, p. 202) determined "by the uncontrollable and disobedient psychology of the business world" (p. 317).

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bailouts; and third, investors must be exposed to a learning process where repeated verifications of bullish expectations lead to diminished risk perception.[22] Excessive asset bubbles are based on the interaction of these factors and include the activity of consumers who expand their time horizons in terms of a consumption pattern that shifts toward goods of higher preference based on an enhanced perception of wealth leading to an equivalent extension of the production structure.

INTERNATIONAL CAPITAL FLOWS

Credit and money are active forces, as they not only affect the structure of the exchange of goods and services but also have a profound impact on the time dimension of an economy's production and consumption pattern. Even under a regime of price stability, the way credit is allocated will change the structure of capital (cf. Garrison 1985). While it is the financial crisis that gets attention and makes authorities apply a host of measures, it has been the excessive creation of circulating credit in the first place that has brought forth the misallocation that is revealed when liquidity gets tight.[23] It is not the outflow of monetary capital that produces the distortions, but it is the massive inflow that makes malinvestment happen. These are brought to light once additional liquidity vanishes.

The difference between the slow build-up of external imbalances in the phase of credit expansion and the rapid contraction of credit is reflected in the asymmetry of the capital adaptation process, when the contraction confronts the debtor country with the task of reshifting its industry from domestic to foreign demand and reorienting production toward internal demand in the creditor country. This process can neither be swift nor smooth, because the adaptation to a new demand pattern is tied to preceding changes of the capital structure. Because the impact of credit expansion and contraction goes beyond financial markets and encompasses the capital structures of the economies involved—both in the debtor and creditor nation—the contraction of

[22]Seen in this light, the ongoing academic discussion of rational versus irrational investment behavior appears as being empty of substance.

[23]In the Asian crisis countries (comprising Indonesia, Korea, Malaysia, the Philippines, and Thailand), annual international bank and securities financing amounted to an average annual inflow of $28 billion from 1990 to 1995 and rose to $58 billion in 1996, only to reverse sharply since 1997, when outflows accumulated to $124 billion until 1999 (BIS 2000, p. 39). Before the crisis, high current account deficits were financed by bank credits, often with a short-term maturity, and internal credit extension to domestic companies expanded rapidly. In 1999, nonperforming loans as a percentage of total loans of commercial banks stood at 6.2 percent in Korea, 38.6 percent in Thailand, 9 percent in Malaysia, and 37 percent in Indonesia (p. 50).

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credit implies a lag between the time period at the financial level, which is abrupt, and the adaptation of the production processes, which is time-consuming and difficult to achieve. While the models of growth-cum-debt[24] presume that economic growth catches up with the payment obligations, there is no guarantee that correlations between investment and growth do hold for the term when financial flows reverse. The inflow of external capital facilitates the parallel extension of the production of consumption and investment goods. As foreign capital inflows add to the availability of funds, an enlargement of the capital base can be initiated without necessarily reducing relative consumption. The more prominent signals of distortion, such as rising prices or higher interest rates, may not show up for some prolonged period of time—at least as long as foreign funds are available. Rapid growth may be deceiving, even if it occurs under conditions of a stable price level. High growth rates may be the result of interventionist policies that make distortions within an economy more rigid, and the measurement of price stability by standard indexes does not guarantee that distortions are not present, given the existence of counteractive deflationary effects from imports and technological progress, and the effects of capital inflows on the exchange rate. But international credit acts destructively once inflationary tendencies or other risk factors appear. It is the ensuing credit crunch that brings economic distortions to the surface.

For a variety of reasons, the swings of expansion and contraction of credit are more pronounced in the international economy than within a closed economy:

- In contrast to credit expansion and contraction in a closed economy, in which the boom-and-bust sequences are mostly limited to individual sectors and only under exceptional conditions affect the whole system, international credit relations often encompass the entire economy and whole regions, and the regional contagion helps to increase the impact on the individual economies involved.
- As the market structure in which the major international creditors operate has quasi-oligopolistic features with strong positions of market leaders, there is a widespread tendency of similar behavior within the group (herding).
- In international financial markets, it is technically easier for the authorities to initiate a bailout, as it is done at the level of government and international organizations. By readily assuming systemic risk,

[24]See Simonsen (1985) for the guidelines that developing countries used in forming their debt strategies.

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the authorities in the creditor and debtor countries tend to initiate various rounds of resumption of expansionary credit cycles.

- The assumption that an international safety net does exist lowers the risk perception of creditors, which leads to an oversupply of credit. The limit to this credit is quite flexible and may only find an end when the authorities lose the willingness for further bailouts or when the distortions become highly manifest.
- International credit relations are deeply interwoven with political and military-strategic aspects, and this, too, will increase the tendency of credit expansion to the ultimate limit, while in the process of contraction the same political elements will cause an acceleration of credit implosion.
- With international credit, there is the additional transmission mechanism of the exchange rate that tends to reinforce the processes of expansion and contraction, making the currency strong as long as the credit inflow continues, and weaken the exchange rate as a result of the capital outflow.
- Government intervention in debtor countries contributes additionally to intensify the credit cycle by applying measures that range from maintaining unsustainable exchange rates to state-guided credit allocation and public deficits. When these policies get out of control, a self-enforcing trend occurs on the downside.

International credit inflows allow a lower monetary interest rate than otherwise, and thus make economic agents overestimate the availability of real funds. The accumulation of foreign debt, which opens the chance for the borrowing country to acquire and maintain higher standards of capital goods, comes along with the expectation of future prosperity that accompanies the extension of the elevated level of production and consumption. Only when credit contraction occurs will it become clear that investors and consumers have extended themselves and that the presumed economic wealth lacks foundation. The contraction leaves projects unfinished, and with the lack of complementary goods, the economy is forced into a process of recessionary adaptation. Even if the occurrence of credit contraction could be forecast,[25] it is

[25]The assessment of international credit risks necessarily contains a plethora of assumptions, none of which is usually very well founded, because the observed variables—such as price stability, stable exchange rates, improved export performance, etc.—are not independent of the stability of the credit inflow itself. In particular, the conventional measures of external vulnerability (IMF 2000) are linked to the external inflows.

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impossible to prepare the capital base of the economy for the change from positive to negative financial flows, because the specific circumstances—beginning with the pattern of relative prices—cannot be foreseen. In order to generate funds for the transfer process, the debtor country's industries must achieve international competitiveness, whose specific form can neither be planned nor implemented in advance but must emerge only with the exposure to the market process itself (Hayek 1978).

In a multi-country world, the transfer process in the phase of credit contraction becomes more complicated when various debtor countries pursue similar paths of export expansion and must face increased price competition. In addition, a successful transformation of the debtor countries' capital base needs the respective readaptation of the creditor countries' production and consumption structure. The transfer process will break down when trade barriers or other forms of government intervention hinder or prohibit the expansion of imports in the creditor countries. As during the process of international credit expansion, the creditor and debtor countries are bound together. In the phase of credit expansion, compatibility of strategies is given, when the debt accumulation and import expansion of the debtor country finds its counterpart in the expansion of the creditor country's export industries. The phase of credit contraction, however, may result in a prolonged stagnation in both types of economies, when political unwillingness or economic frictions poses barriers against the adaptation that is required to take place at the level of the real economy in face of the reversal of financial flows.

CHANGING THE PARADIGM

In a passage from the *General Theory* that apparently was directed at the Mises-Hayek theory of the business cycle, Keynes put forth the proposition that

> the remedy for the boom is not a higher rate of interest but a lower rate of interest! For that may enable the so-called boom to last. The right remedy for the trade-cycle is not to be found in abolishing booms and thus keeping us permanently in a semi-slump; but in abolishing slumps and keeping us permanently in a quasi-boom. (1936, p. 322)

Besides being vulnerable to theoretical objections, however, this fascinating promise does not live up to the facts. Seen in the light of decades of experience, it is the application of various concoctions of the Keynesian recipe that has produced the "quasi-slumps"—like the stagflation period of the 1970s, the enduring debt crisis of developing countries, and the continuation of the Japanese stagnation. Nevertheless, the attraction of applying Keynesian policies is still appealing today. It comes from the short-term effectiveness of

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expansive measures when distortions are still mild. But by trying to create a continuous "quasi-boom," there is not just the danger that the boom will get out of control and an inflationary spiral will be triggered but also that more distortions will be produced, finally becoming so severe that there will be no longer an immediate cure.[26]

Facing a potential slump, economic policy is confronted with choosing between the applications of new expansive measures in fiscal and monetary policy or of letting the markets do the re-equilibrating. But while there is always the attraction to pursue "active policies" as long as these are seen to bring relief in the short run, interventionism comes with high costs, although these are less visible than the immediate burdens of nonintervention. It is this asymmetry that puts the Austrian theory of the business cycle at a political disadvantage; it expects quite a high degree of insight and courage from policymakers. Although short-term, "active" economic policy has political popularity on its side and finds support in the Keynesian streaks of economic theory, it is not necessarily rational economic policy. In contrast, Austrian economics provides a theory of the long run, and it is in the long run that all bills come due.[27] As long as the attitude of *après nous le deluge* does not become the guideline of public action, it is politics, which takes the long-term effects into account, that deserves the attribute of rationality. The long-term perspective is ingrained in the method of Austrian economics as it uses sequential analysis of causal links in time in order to detect not just the immediate but also the more remote effects of actions. The special status of open markets and an intervention-free price system comes from the same type of dynamic analysis, which brings to light that although there never can be the perfection of an equilibrium state in the real world, free markets drive human actors to constantly work toward such a situation. But when assumptions get repeatedly verified that there are government guarantees and that the risk of losses will be nullified because central banks and governments stand "ready to act" and will provide emergency financing, capital misallocation will be the inevitable consequence.

In the more specific context of macroeconomic policies, adopting an Austrian perspective implies that monetary policy is ill-advised to neglect excessive credit growth, the money supply, insufficient savings, unsustainable

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[26]Keynes himself made it explicit that his remedy for the trade cycle is the substitution of one malinvestment by another one. If one pyramid is not enough, build a second one! But it does not take much fantasy to see that this kind of economic policy, while probably creating full employment, is a map for the road leading to capital destruction and poverty.

[27]This way, Austrian economics carries on the tradition that was the trademark of classical political economy (see, for example, Holcombe 1999).

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current account balances, and the burden of external debt in favor of overemphasizing economic growth, employment, and price stability. In the light of Austrian economic theory, high investment and growth rates and even rising productivity may be deceiving when they occur as the result of interventionist policies and credit growth that induces capital misallocation. Bailout guarantees–also when their ascribed function is "to stabilize the system" and as such are undertaken in the seemingly unspecific form of monetary and fiscal measures–undermine the proper functioning of the capitalist system. Like other interventions, they destroy the signaling and sanctioning apparatus linked to losses. Free markets and a strict profit-and-loss-system are the best ways to signal erroneous action and induce the constant process of corrective adaptation to bring forth efficiency in the allocation of capital.

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THE "CONFEDERATE" BLOCKADE OF THE SOUTH

ROBERT B. EKELUND, JR., AND MARK THORNTON

> Commercial non-intercourse was greeted as the strongest weapon of coercion, but proved to be a useless one . . . it was used as an adjunct to military operations, and in so far as it was effective–in the case of the South, whether as a result of the Federal blockade or of Confederate legislation–it weakened the country for waging war effectively by shutting off foreign supplies. (Schwab 1969, p. 265)

There is no shortage of theories to explain the victory of the Union government over the Confederate government,[1] but most explanations rest on the conclusion that the North defeated the South because it was larger in terms of labor and capital.[2] Corollary views are that the Confederacy was underdeveloped in terms of national identity and government structure or that slavery and free trade made the South deficient in industrial capital and free labor to arm and fill the ranks of its army.[3] In contrast, the economic analysis of war is not based primarily on the quantity of resources, but on the ability to use those resources efficiently for both military and civilian purposes.[4]

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[1]On the continuing interest in this question, see especially Boritt (1992) and Gallagher (1997).

[2]For examples of the "Traditional View," see Jones (1909), Beringer, et al. (1986), and Current (1960, p. 22), who argued that the differences in resources was too great for the South to win and that "God was on the side of the heaviest battalions."

[3]See, for example, Owsley (1925) for the prominent view that "states' rights" prevented the Confederate government from obtaining necessary supplies and soldiers.

[4]This view, as adopted within the Austrian School, is expressed in Mises (1949).

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Some historians have come to believe that the South had sufficient resources to achieve independence, but they blame its defeat on the incompetence of Confederate leaders. These historians claim that the Confederacy should have pursued a more aggressive interventionist economic policy with the goal of creating a powerful central government capable of transferring more resources from the economy to the military.[5] Louise Hill (1936) described the Confederacy as "the most successful demonstration of State Socialism to be found up to the time in modern civilization," suggesting that the Confederacy lost because it failed to adopt socialism and, in particular, failed to nationalize international trade in a timely manner.

Given that the smaller and poorly equipped armies of the Confederacy regularly defeated or fought to a stalemate the larger and better-equipped armies from the North, it is apparent that some additional economic factors determined the ultimate outcome of the Civil War. It is here that the Union blockade of the Confederacy takes center stage. Blockades are notoriously difficult and costly to enforce, and at the outbreak of hostilities the Confederacy had a distinct naval advantage with its extremely long coastline offering numerous established ports and deep-water harbors. The Union did have more ships and sailors than the Confederacy at the beginning of the war, and the overall number of ships and sailors ensured that it would only be a "paper" blockade.[6]

As the war progressed, the Union expanded its navy, blockade fleets, and bases of operation on the Southern coast. International trade with the South fell dramatically when the war began, and private trade was nearly extinguished by the end of the war. A large number of writers have found the decrease in international trade to be a significant contributing factor in the economic and military collapse of the Confederacy.[7] As a cornerstone of Union war

[5]President Jefferson Davis has been often criticized for his leadership. The complaints directed toward him usually center on the failure or delay in obtaining the traditional resources for war, such as nationalization of transportation (railroads), heavy taxation, blockade regulations, and the conscripting of slaves. Note that this explanation becomes, in effect, a "states'-rights" argument because all of these failures rested on Davis's reluctance to infringe on the sovereignty of the states, impinge on private property, or to violate international law.

[6]At the beginning of the Civil War, the Union could only launch three steamers and lost nearly three hundred naval officers because of allegiance to the Confederacy. The South had more than three thousand miles of coastline, with Bermuda, Nassau, Havana, and Mexico within short distance of its borders.

[7]Bern Anderson (1962), E. Merton Coulter (1950), Mary Elizabeth Massey (1952, 1965), Charles Roland (1960), and James Soley (1883). No one to our knowledge claims that the blockade did not play a role in the Union victory. Noted historians Frank Owsley (1931) and Frank Vandiver (ed., 1947) found the Union blockade to be ineffective, as did many high officials in the Confederate government (Beringer, et al., pp. 58-59). However,

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strategy, the blockade would have appeared to be the first and most important blow struck by the Union.[8] The blockade not only directly thwarted the Southern economy but also contributed to the demoralization of the Southern people by encouraging the importation of luxury goods during the war.[9] Civil War scholar John Schwab described the blockade as the "most powerful tool at the command of the Federal government in its effort to subdue the South." Schwab concluded:

> [W]e lean to ascribing to the navy the larger share in undermining the power of resistance on the part of the South. It was the blockade rather than the ravages of the army that sapped the industrial strength of the Confederacy. (1969, p. 236)

However, while the presence of the blockade fleet was certainly a necessary condition to shutting down international trade, it was not sufficient. The blockade fleet made it more costly to transport goods, but the percentage of blockade-runners that were actually captured by the Union blockade fleet was small.[10] Important research has now shown that the Union blockaders posed little threat to the blockade-runners. The blockade fleet did have an economic incentive to capture blockade-runners because the "prize" would be divided between the officers and crew. However, those same incentives meant that the blockaders did not want to harm the blockade-running ships for fear of destroying valuable prizes, particularly the outgoing vessels that were loaded with cotton. International law protected captured members of the crew, who were typically released in port and available for more blockade running. The risk of death or injury faced by blockade-running crews was significantly less than those faced by Confederate soldiers (Neely 1986).

We show that Southern trade and the Southern economy were primarily harmed by the Confederate government's economic and military policies. The Union blockade fleet and coastal bases *were* a necessary condition, but it was the

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these conclusions are based on the fact that the government was capable of getting most of its supplies across the blockade, but ignores the fact that the government was able to do so only by crowding out private trade with extreme measures and at high cost.

[8]General Winfield Scott, commander of the Union army at the beginning of the conflict, devised the "Anaconda Plan" that consisted of four main elements: (1) conducting a naval blockade of the Southern coast; (2) opening the Mississippi River, thereby severing the South into two parts; (3) applying military pressure and controlling territory along the land border, and ultimately invading the center of the South; and (4) capturing the Confederate capital. Scott's planning foreshadowed both the course and length of the conflict.

[9]Ekelund and Thornton (1992) show that blockade-runners resorted to shipping more "luxury" goods (goods with high value relative to size and weight) in response to a tightening blockade, a response to economic incentives dubbed the "Rhett Butler effect."

[10]As described in the data provided by Price (1948, 1951, 1955). Lebergott (1981) estimates the probability of capture at 16.5 percent.

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policies of the Confederate government that made the closure of international trade and the destruction of the Southern economy possible. These misguided policies, more than any other factor, explain the unusual and unexpected effectiveness of the blockade in reducing trade and, ultimately in the defeat of the Confederacy, a result we label the "Confederate blockade of the South."[11] This conclusion extends Stromberg's (1979) thesis that the Confederacy died of over-centralization, a position more fully elaborated by Hummel (1996).

SOUTHERN ECONOMY AND CONFEDERATE POLICY

Prior to the Civil War, resources in the South were allocated almost exclusively on the basis of comparative advantage and free trade. As a result, the South grew rapidly and developed a thriving agricultural economy with a comparative advantage in cotton. Cotton was the fuel of the Industrial Revolution, and the South was the largest producer and exporter of raw cotton. It also produced other export crops, such as rice, sugar, tobacco, and large amounts of meat and grain. However, it only produced limited amounts of manufactured goods.

According to Lerner's estimates, the value of Southern manufacturing in 1860 was $155.5 million. The bulk of this manufacturing was based on agriculture or locational cost advantages. The number of manufacturing firms in the South represented 14.7 percent of the national total in 1860, but Southern products represented only 8.2 percent of the total manufacturing value, indicating that Southern manufacturing, on average, was based on a smaller scale of production than manufacturing in the North. The gross farm income of the South in 1859 was $575.5 million ($277.6 million in cotton alone), or almost four times that of manufacturing. The comparative advantage of the antebellum Southern economy was clearly in agriculture (Lerner 1959, pp. 93 and 102).

While the Northern economy was relatively diversified, the Southern economy was highly specialized in the production of export crops. The Confederate government could have adopted a strategy that exploited their comparative advantage in international trade, but instead adopted a de facto strategy of ersatz[12] where a nation abandons international trade in favor of

[11]This result is consistent with Lebergott (1981), who estimated that the overall rate of ex ante profit, adjusting for costs and risks, was about the same as the rate of profit of new capital employed in England during the war. In other words, markets worked and blockade-runners were rational. In addition, Lebergott found that many successful blockade-runners only made one round trip through the blockade. He suggests that the risks and lack of profit deterred the successful runners from additional trips and limited the extent of the cotton trade. We agree, and suggest it was the "Confederate" blockade that was the reason for these insufficient profits, an explanation that is implicit in Lebergott (1981, see esp. pp. 868 and 877).

[12]Ersatz refers to substitution, usually an artificial and inferior substitute or imitation, when the preferred good is not available. See Massey (1952) for a description of ersatz measures taken in the South during the Civil War.

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domestic production and the use of inferior substitutes for goods that it cannot produce. The Confederacy's "King Cotton" philosophy led to the adoption of policies such as protectionism and the cotton embargo that discouraged the production and export of cotton. In addition, the Confederate government impressed merchant ships and acquired naval vessels, not for the purpose of breaking the blockade and enhancing international trade, but only to protect cities and the industrial plants that they contained. By the end of the war, the Confederate and state governments were involved in the domestic manufacture of every element of military hardware and weaponry, and they controlled large sections of the economy, including railroads and international trade. Germany followed this type of ersatz policy during both the world wars and suffered greatly, even though it was a relatively large and diverse economy. The economic suffering from a policy of ersatz would be expected to be relatively more severe in the highly specialized economy of the South.[13]

KING COTTON AND THE COTTON EMBARGO

Before the war, David Christy argued in *Cotton is King* that cotton produced on Southern plantations fueled the Industrial Revolution and was therefore a powerful economic tool in international affairs. According to this view, "King Cotton" controlled textile manufacturing both in the North and in England where as many as five million workers were employed. Advocates of this thesis thought that in the event of an invasion or blockade by the North, an embargo would cause a shortage of cotton in Europe, devastate the European and Northern textile industries, and force England and France to break the blockade.[14] According to Owsley (1931, pp. 15-17), "King Cotton became a cardinal principle upon which the men who were to lead the South out of the Union and to guide its destiny through the Civil War were almost unanimously agreed."

In the early days of the Confederacy, advocates of King Cotton petitioned Congress for cotton embargo legislation. While they were unsuccessful in obtaining this legislation, Jefferson Davis and his administration lent "tacit approval" to the embargo (Wise 1988, p. 28). More direct success was achieved at state and local levels, where state laws were passed and citizen

[13]Mises (1949, p. 829) points out that the American Civil War was really the first war where the problems of the international division of labor played a decisive role.

[14]This boycott concept does have some grounding in American experience. It was used somewhat successfully at the beginning of the American Revolution, although it was unsuccessful when Jefferson employed it against the British during the Napoleonic Wars. Britain would probably have succumbed to the cotton embargo if not for contrary interests, such as their demand for Northern wheat and munitions sales.

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committees applied extralegal pressure against cotton export (Schwab 1969, pp. 250-01). As a result, a de facto embargo on the export of cotton was established in the early years of the war. According to Civil War historians Randall and Donald, "The extraordinary difficulty of getting cotton out of Southern ports in 1861 justified the Southern representations abroad that an 'air-tight embargo' on the export of cotton had been put into effect."[15] At the same time the threat posed by an effective blockade was virtually ignored (Wise 1988, p. 25).

The failure of the Confederate government to act decisively, one way or the other, had a negative effect on its overall foreign policy by creating the impression in Europe that King Cotton was nothing but a paper monarch because cotton was readily available. Europeans, anticipating a disruption in the supply of cotton, established large inventories prior to the actual beginning of the war.[16] Concurrently, the embargo helped provide evidence that Lincoln's "paper" blockade was legal because the importation of Southern cotton into Europe was greatly diminished. In other words, the South would have been better off had the Confederacy either strictly enforced a comprehensive embargo or aggressively stimulated the export of cotton. On the one hand, a comprehensive and binding embargo might have threatened European textile interests by changing market expectations and driving the price of cotton in Europe to extremely high levels. On the other, a policy of aggressive exports would have provided clear evidence that the Union had imposed an illegal "paper" blockade and permitted European intervention to end the blockade. Either policy would have increased the possibility of European intervention early in the war, and most experts agree that an end to the blockade would have meant an end to the war.

IMPRESSMENT POLICY AND BLOCKADE-RUNNING

The Confederate policy of impressing goods for military use at below-market prices created bitter feelings toward the government on the part of those who

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[15]Randall and Donald (1969, p. 501). In the first year of the war, exports of cotton declined by more than 99 percent. "During the season 1860-1 New Orleans exported one and a half million bales of cotton; during the following season the amount fell to 11,000. The total exports of Southern cotton during the same time fell from two millions of bales to 13,000." Production of cotton remained high early in the war, with almost four million bales produced in 1861 (Schwab 1969, pp. 238, 279). These wartime numbers are "official" figures that are probably much less than the actual exports due to the chaotic conditions, evasion of the cotton tax, and other restrictions.

[16]In addition to being able to draw down its inventory of cotton, England faced a drop in demand for its cotton products, and was suffering from a shortfall in wheat production (which it imported from the Union). As the war progressed, labor shifted from cotton textiles to munitions and war goods. The increase in the price of cotton resulted in new sources of supply, from such faraway places as Egypt and India (see Surdam 1998).

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were adversely affected.[17] It also resulted in an overall decrease in the supply of provisions, hoarding by civilians and the military alike, general waste, and in some areas the policy deteriorated into mere robbery (Schwab 1969, pp. 202-07). And yet when historians turn their attention to the impressment of ships as a naval procurement policy, it is often viewed as necessary and a generally beneficial aspect of the war effort. In reality, the impressments of ships had the same predictable effects and helped increase the effectiveness of the blockade.

According to economic theory, obtaining ships via impressments will decrease the total supply of ships available for either naval or commercial purposes, because below-market prices discourage future production and supply. Combined with the faulty cotton embargo, the impressments of ships in Southern ports greatly curtailed the South's international trade at a time when the blockade was ineffective and when European goods such as marine engines, railroad machinery, rifled cannons, and repeating rifles could have been imported at costs much lower than later in the war. Between 1860 and 1864, the cost of transporting goods through the blockade increased by 5,000 percent.[18]

After ships of foreign ownership had departed Southern harbors in 1861, there were only ten oceangoing steamers in the Confederacy. Several of these steamers were immediately seized or impressed by the government, and all of them would "eventually be taken over by the Confederate Navy" (Lebergott 1983, p. 26). The ships that could have been used to help defeat the paper blockade of 1861 were seized by the Confederate and state governments. This not only prevented their use for profitable purposes, but it established a precedent that threatened potential suppliers of steamers and thus curtailed the availability of a crucial resource to run or break the blockade.

Impressments typically result in wasted resources because government officials are able to consume resources at below-market prices; therefore, it is not surprising that the impressed ships of the South were not very effective military instruments for the Confederacy.[19] Two of the largest and newest

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[17]See for example, Lebergott (1983, pp. 70-73). He argues for the traditional view that the North won because of its size advantage and because the South was overly concerned with laissez-faire philosophy, but his evidence on impressments policy actually supports the view that Confederate policy distorted production and reduced economic output.

[18]See Lebergott (1983) for details of the rapid increase in transportation charges. He estimates that the specie cost of transport increased by almost 5,000 percent from 1860 to January 1864.

[19]The waste generally occurs because officials remove too many resources from the economy at the below-market prices and allocate them to lowered value uses. In many cases, impressed ships were quickly and unnecessarily destroyed, captured, or put to unproductive purposes.

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steamers were seized by the navy of Virginia and turned over to the Confederate States Navy. The *Jamestown*, renamed the *Thomas Jefferson,* was sunk as an obstruction in the James River, while the *Yorktown*, built in 1859, became the home of the Confederate Naval Academy. The largest available steamer, the *Nashville*, was seized at the start of the war for the Confederate navy, but only contributed to the war effort after it was sold to private interests in 1862 (Lebergott 1983, pp. 26 and 230).

A policy of obtaining goods via impressments means that suppliers are forced to give up their production in return for prices below those that would be set in the market and thus they are not being compensated for the true economic costs and risks they face. When production is not profitable, suppliers are unwilling to produce, and market prices rise even higher. Confederate impressments clearly made Southerners less willing to supply vital goods such as corn. Although unrecognized by historians, the policy of impressing ships likewise diminished the supply of ships. For example, the Confederacy found foreign producers reluctant to provide ships. Also, domestic shipbuilders often demanded lucrative terms in their contracts with the Confederate government. The Confederacy was thus forced into high-cost government-run production in order to obtain the desired number of ships. These well-known problems were due, at least in part, to poorly devised Confederate policy.

NAVAL POLICY AND SHIPBUILDING

Confederate Secretary of the Navy Stephen Mallory stated (in retrospect) that, given their limited resources and the overwhelming resources of their opponent, the Confederate States Navy "accomplished more than could have been looked or hoped for; and if I have ever felt any surprise connected with its operations, it was that we accomplished so much." However, even he had to admit that only one in a thousand Southerners appreciated the navy's contribution to the war effort (Mallory 1867). The principal historians of the Confederate States Navy emphasize the tremendous difficulties it faced, the successes it achieved, and its inventive spirit. Their ingenuity resulted in the introduction of ironclad ships, torpedo boats, mines, and even the submarine. However, all of these historians clearly agree that the Confederate States Navy, in the end, was a failure because it did not lift the blockade and relatively few of its ships were ever put into effective action.[20]

One of the most significant economic failures of the Confederate States Navy was its often-cited success: the ironclad. Initially the Confederacy planned to purchase its sea-going navy abroad and build numerous small

[20]See Still (1985, 1987), Luraghi (1996), and Soley (1883, p. 24) who considered the activities of the Confederate navy to be "little less than phenomenal."

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wooden gunboats for the defense of harbors and rivers.[21] This made economic sense because Southern shipyards were capable of making small wooden gunboats but were at a comparative disadvantage to Europe in the construction of effective war ships. However, the success of the *Virginia* and the *Atlanta* convinced Secretary Mallory and the Confederate government officials that an all out effort should be placed on building a fleet of fifty ironclad ships. This fleet would patrol and defend the coastal and river cities and destroy the Union blockade.[22] The South simply did not have the shipyards, raw materials, mechanical inputs, skilled labor, and, most important, the time to build this fleet (Still 1987). As a result, the Confederate ironclad-building program was not successful and even more significantly, the ships that were built were built at a high opportunity cost, especially in terms of iron. Construction was begun on approximately fifty ironclads, but only twenty-two were completed; most of these were captured or destroyed shortly after being commissioned. Some of the ironclads had longer but less eventful careers in harbor defense. Ironically, several ironclads had more productive careers in the Union navy after being captured.

Lost within the calculations for the ironclad-building program was the opportunity cost of local material acquisition and construction to the Southern economy and war effort.[23] The South was iron-poor and was forced

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[21]The steam-powered wooden gunboats would be of light draft and sit low in the water so as to be difficult to hit. There would be no crew accommodations of any kind, and storage would be limited to coal and munitions. The gunboats had the advantages of being "easily" constructed throughout the South and requiring a small crew. The gunboats could also have served in support of the land forces, enhanced communication, and served in reconnaissance. Originally designed to carry two rifled pivot guns, the design could have been adapted for carrying a large rifled cannon, mortar, ram, torpedo, floating mines, fire boats, and signal rockets. The gunboats might have been further protected by installing more powerful engines or some cotton or iron cladding as experience or circumstances dictated.

[22]We note that a policy of protecting the cities rather than opening the blockade had a negative impact on privateering. We also note that a more successful privateer effort by the Confederacy would also have reduced the effectiveness of the blockade by diverting blockaders toward the protection of commercial shipping. Privateering was stymied early in the war by Lincoln's efforts to hang privateers, and later in the war by the lack of open ports (either Confederate or European) in which the privateers could claim and sell their prizes.

[23]We do not argue that the Confederacy did not need any ironclads. A successful harbor defense would require ironclads of the floating battery type as a supplement to harbor mines, underwater obstructions, and forts with powerful rifled cannons capable of sinking ironclads at a distance. Floating batteries were slow-moving or anchored ships, nearly impregnable to shot or ram. They could block ship channels to an invading armada with a small number of guns, if supplemented with mines, obstructions, and forts. (The batteries did not necessarily have to stop ironclads, only to stop or prevent wooden ships and troop carriers from passing.) Seagoing ironclads to lift the blockade would have been best procured in Europe or built in New Orleans, had the city not been lost so early in the war.

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to defend its only major ironworks in Richmond "at all costs." Confederate and state governments engaged in costly efforts to stimulate iron production, but these efforts diverted precious labor away from its comparative advantage and resulted in little additional iron supply. The high cost of iron was revealed in the cannibalization and depreciation of the South's railroad system. The Confederate government used the prewar supply of replacement rails and the iron rails of existing lines to build and clad ships. The dismantling of railroads, the inability to build new rail connections, and the depreciation of the remaining rail system was an important factor in the defeat of the Confederacy.[24]

The Confederate States Navy plan to build ironclads instead of building gunboats and purchasing blockade busters abroad was a major economic mistake.[25] This plan did not protect the Southern economy or open the blockade and contributed directly to military defeat by diverting essential resources into iron production and shipbuilding. The redeployment of iron rails and engineers away from the railroad system to the ironclad-building program undermined the South's military advantage of interior lines of transportation by which soldiers and materials could be quickly moved from one point of attack to another.[26]

PROTECTIONISM

Broadly speaking, the South had a tradition of classical liberalism that supported free trade and a free-market economy, while Northern economic philosophy was more interventionist. The North supported funding the federal government via tariffs that protected their manufacturing industries, while the South opposed high tariffs because it meant higher prices for the goods they purchased and a lower return on their exports. The tariff revenue, however, made up the bulk of federal funds, most of which was spent in the Northern states. In fact, the ongoing dispute in Congress over tariffs was a primary reason for the secession of the Southern states. The Morrill Tariff, subsequently, became the impetus for Lincoln's call to arms.[27] Indeed, Republican government both during and after the war maintained what economist Frank Taussig

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[24]See especially, Turner (1953) and Johnston (1959). According to Ransom (1989, pp. 194-95), "The problem was that the transportation network of the Confederacy was not up to the task of moving large quantities of supplies to the armies of Virginia. . . . Eventually, the wear and tear of heavy use without adequate repairs took its toll."

[25]They did plan at the beginning of the war to buy navy ships in Europe to break the blockade, but the plans were changed. Also, late in the war, they proceeded to buy a blockade-running fleet, but only a few of these ships participated materially in the war effort.

[26]Many commentators, including General Robert E. Lee, complained that new and existing rail connections between interior cities should have been made a priority.

[27]See Denson (1997), DiLorenzo (1998), and Adams (2000).

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(1888, pp. 341-42) described as "very high protective duties." Given its prewar stance, it is ironic that by the end of the war the Confederacy would enact many protectionist-type policies of its own. However, these policies were designed to increase government revenue, not to protect the domestic industries of the South.

Confederate and state governments greatly expanded their interventionism during the war and transformed a largely free-market, agricultural economy into one of pervasive government intervention.[28] Protectionist policies such as regulations, taxes, and prohibitions were enacted during the war that discouraged international trade, on which the Southern economy was so dependent, and increased the apparent effectiveness of the Union blockade.[29] Confederate and state governments also competed in the blockade-running business, further dampening the profit expectations of blockade-runners.[30]

Early in the war there was a great deal of free-trade agitation.[31] In fact, legislation was presented to the Provisional Confederate Congress that would have created a free-trade policy, but it was defeated. A similar bill was presented to the First Confederate Congress, and although favorably received in the House of Representatives, the Senate did not act on it before the session ended. After that, sentiment moved toward greater, rather than less, protectionism (Schwab 1969, pp. 245-46).[32]

In mid-February 1861, the Provisional Confederate Congress retained the Customs officials of the United States *and* the existing tariff laws, although it did establish a "free list" for food, provisions, and army supplies, as well as all goods purchased before the end of that month.[33] At the end of February, a tax on the export of cotton was enacted that provided for a levy of one-eighth

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[28]See for example Hummel (1996, esp. chap. 9).

[29]It is worth noting that Confederate policies were often evaded, especially its taxes on imports and exports, but this does not eliminate the cost of the policy or remove their negative economic impacts on the incentives to produce and distribute goods.

[30]This dampening of expectations might have been particularly acute near the end of the war as Confederate ports were falling into enemy hands and as new Confederate blockade-runners were expected to come into service. The resulting severe constraint on port services would have made private blockade-running extremely tenuous.

[31]For example, the Commercial and Financial Convention in association with the Convention of Cotton Planters recommended complete free trade during its convention of October 14-16, 1861.

[32]One private citizen who attempted to establish the volunteer navy of the Confederate States was "hampered by the difficult export regulations" in getting his cotton sold. He was also stymied by the blockade, which had become more effective while he was awaiting permission from the Confederate Congress (Robinson 1990, p. 335).

[33]If this free trade window had been expanded from ten days to ten months, it could have had a material impact on the outcome of the war by alerting Europeans of the opportunity to import goods duty free at a time when the blockade was particularly ineffective.

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of one cent per pound. Two weeks later, a 15 percent ad valorem tax was placed on imported coal, iron, paper, and lumber. The tariff was further "elaborated" less than one week later. Both the import and export duties failed to raise revenues, which is a clear indication of their negative impact on trade.[34] The Confederacy also placed heavy taxes on foreign credits in an attempt to tax the "extravagant" profits of blockade-runners (Schwab, 1969, p. 243). The Cotton Bureau of the Confederate States of America required a permit to export cotton. The bureau used these permits to purchase cotton from farmers, and the farmers in turn sold the permits to blockade-runners. The net effect was to double the cost of cotton purchased for export within the Confederacy (Lebergott 1981, pp. 868-69).

Obviously, protectionism had the effect of making it more difficult to import and export goods and materials needed by individuals, businesses, and governments because it reduced income from international trade and reduced the number of ships engaged in blockade-running. The protectionist regime also created the scenario in which the implicit costs of smuggling would rise. As Lebergott (p. 877) notes, to earn normal profits a blockade-runner must not only be well run, but must also be "well connected, with few problems readily acquiring cotton on time, and getting clearances," requirements that depended on special connection and government bureaucrats, not business efficiency. As a consequence, protectionism would force the Southern economy to rely more heavily on the policy of ersatz.

REGULATION, PROHIBITION, AND NATIONALIZATION

As the war continued and the blockade tightened, the interventionist tide continued to swell in the South as both Confederate and state governments entered the blockade-running business. The Confederate government operated four steamers out of Wilmington, North Carolina to run the blockade with cotton and return with arms, munitions, and provisions. Governor Vance of North Carolina established a state-run blockade-running operation in 1862, while Georgia and South Carolina entered into joint ventures to reap the profits of blockade-running and, in part, to exempt local firms from the onerous Confederate requirement that blockade-runners set aside 50 percent of cargo space for use by the Confederate government.[35]

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[34]The export duty on cotton was optimistically estimated to result in revenues of $20 million, but only brought in approximately $6,000 in specie during the war. Treasury Secretary Memminger estimated that the tariff would bring in $25 million per year, but it had raised only $1 million by September of 1864 (Schwab 1969, pp. 240-42).

[35]The case of the *Little Ada* is the most revealing illustration of the "partial blockade of our own Executive," as expressed by President Davis. Governor Brown of Georgia refused to allow the Confederate government space on the *Little Ada*, and President Davis

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In response to public dissatisfaction over the import of luxury goods, legislation was passed in February 1864 that forbade the import of many luxury items, including alcohol. This prohibition, which is generally viewed by historians as a policy that was "too little and too late" in regulating the blockade-runners, had a doubly negative impact on the war effort.

First, luxury goods are high in monetary value relative to their bulk, and, therefore they contributed greatly to profits. Many of the captains, officers, and crew of blockade-runners were allowed to bring in a small number of goods on their own account in order to enhance their pay and the prospects of a successful voyage. They almost always imported luxury goods, which gave them the greatest return. By outlawing luxury imports, the Confederacy was unwittingly decreasing the supply and increasing the price of blockade-running services.

Second, the act prohibited the import of beer, spirits, and wine, which, when combined with state prohibitions of alcoholic beverages, created an extreme scarcity for products that traditionally had been served to sailors and soldiers as part of their food rations. Whiskey was a practical substitute or supplement for bread and in fact surpassed bread in terms of being a more durable, transportable, and versatile grain product, especially under battlefield conditions. General Joseph E. Johnston, for example, decided to use whiskey to make up for deficiencies in the meat rations of his men. Alcohol was a regular component of a sailor's rations (as recommended by the Surgeon General) and was, of course, an indispensable medical commodity.[36]

The Confederate Congress also authorized the Treasury Department in February 1864 to regulate the export of cotton, tobacco, military and naval stores, rice, and sugar. Shortly thereafter, the Congress required half of the outgoing and incoming cargo space to be reserved for the Confederate government. This legislation had a highly negative impact on blockade-running and the economic viability of the South.[37] Shortly after the passage of

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refused the ship clearance to run the blockade. During the ensuing political squabble the presence of the ship was reported to the Union blockaders who, in a surprise raid, captured the ship in port but were ironically denied their prize by the Confederates who were blockading *in* the *Little Ada*!

[36]According to Robinson (1931, pp. 51-53), most states had passed prohibitory laws during 1862 and as a result, "the price of whiskey jumped skyward." In addition to industrial uses, the War Department used "considerable amounts of whiskey" in hospitals and to produce medicines (see also Frank 1955). The regular issue of whiskey had to be suspended in 1863 because of a short supply. According to Durkin (1987, p. 329), Secretary of the Navy Mallory even tried to establish a distillery in South Carolina to produce whiskey for navy use.

[37]Data from Price (1948, pp. 232, 236) on blockade attempts through Carolina ports in 1863 and 1864 carry the presumption that attempted runs sharply diminished between these two years (from 515 in 1863 to 387 in 1864). The number of runs through the blockade at Wilmington by steam-powered ships was about the same the year before

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the legislation, Captain Roberts, one of the most successful blockade-runners, ceased all blockade-running, saying:

> The game, indeed, was fast drawing to a close. Its decline was caused in the first instance by the impolitic behaviour of the people at Wilmington, who, professedly acting under orders from the Confederate Government at Richmond, pressed the blockade-runners into their service to carry out cotton on Government account in such an arbitrary manner, that the profit to their owners, who had been put to an enormous expense and risk in sending vessels in, was so much reduced that the ventures hardly paid. (1967, p. 51)

Another famous and successful blockade-runner was Thomas Taylor, who made twenty-eight trips through the blockade. One of his very first recollections in his chronicle of events was the Confederate government's 1864 act to limit freight on private account and its prohibition on imported luxuries. Unlike Captain Roberts, Taylor (1971, p. 139) continued to run the blockade because he had negotiated a secret profit arrangement with the Confederate commissary-general that compensated him for the 1864 legislation. Late in the war, despite his best efforts to the contrary, Taylor accurately predicted the downfall of the Confederacy.[38] As he put it, blockade-running should have been encouraged rather than discouraged by "having obstacles thrown in the way."

> I am convinced that *the conditions of affairs would have been altered very materially*, and perhaps would have led to the South obtaining what it had shed so much blood to gain, viz. its independence. (pp. 137-38, emphasis added)[39]

It seems that blockade-runners could adjust to the advances of the Union blockade, but not to the economic constraints of Confederate legislation.[40] As Captain Roberts (1967, p. 51) explains, "The enterprise had lost much of its charm; for, unromantic as it may seem, much of that charm consisted in

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the legislation as the year after. Given that most other ports were occupied or effectively blockaded in 1864 and 1865 and that a number of new private and public steamers had come on line in 1864, we would have expected blockade-running into Wilmington to have substantially increased.

[38]Taylor wrote to his superiors on January 15, 1865, "I never saw things look so gloomy, and I think spring will finish them unless they make a change for the better." He noted that he had successfully delivered all of the Whitworth guns to Fort Fisher and food "enough to feed Lee's army for a month" (pp. 137-38).

[39]It has been suggested that Taylor was the real-life model for Margaret Mitchell's character of Rhett Butler. It is interesting to note that even Rhett Butler withdrew from blockade-running during the period after the 1864 legislation.

[40]Browning (1980, pp. 175-79) found that, despite a tremendous increase in the number of blockading vessels off Wilmington, the number of blockade-runners captured each month stayed about the same.

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money-making." Bradlee (1974, p. 62) also acknowledges that the restrictive legislation caused a reduction in blockade-running, a reduction that caused critical shortages and logistical bottlenecks in late 1864 and early 1865.[41]

CONCLUSION

In order for the Confederacy to achieve independence it had to survive long enough for the Union government to be defeated politically.[42] The South had a military comparative advantage in defense and an economic comparative advantage in the production and trade of cotton, but the Confederacy failed to consistently employ these advantages and therefore contributed to its own demise.[43]

Despite a prewar philosophy that emphasized free trade, the Confederate government enacted legislation that served to suppress international trade.[44]

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[41]Prior to the war, the South produced enough meat for its population, but most of the meat was produced in Texas and could not be transported effectively during the war to Virginia. Therefore the blockade of the Gulf of Mexico forced Virginia to rely heavily on meat run through the blockade at Wilmington and through enemy lines. The reduced flow of goods through the blockade, combined with General U.S. Grant's termination of the meat-for-cotton trade, starved Lee's army out of the trenches around Petersburg and Richmond (also see Surdam 1993).

[42]The election of 1864 was such an opportunity. According to Anderson and Tollison (1991, pp. 223-24), "Lincoln sensed that his reelection was in doubt" during the summer of 1864 and that only the votes of "loyal" troops prevented the election from going to the peace-oriented Democratic ticket headed up by George McClellan, who had been discharged by Lincoln as commander of Union forces. Of lesser note were the elections in Ohio in 1863 where, according to Roseboom (1952, p. 44), a Peace Democrat victory could have had "dire effects for the cause of the Union, or . . . might have hampered the states war effort. Even more important, the peace movement all over the North would have been immeasurably strengthened and Union morale dealt a devastating blow." As Lincoln put it, Ohio had saved the Union.

[43]In a similar vein, David Surdam (1994a, 1994b, 1998) has demonstrated that the underlying world demand for Southern cotton remained strong and that if the Confederacy had continued to trade but used its price-setting power on cotton that much of the cost of the war could have been shifted onto the consumers of cotton while at the same time increasing manpower for the army. This would have required the Confederate government to organize a cartel-like institution that would reduce output and increase the price received for Southern cotton with the resulting profits used to pay for the war effort. The combination of financial viability and an enlarged military or civilian work force would have made the Confederacy a more formidable opponent.

[44]The Southern disposition toward a Jeffersonian or libertarian-type society can be seen in the "improvements" made in the Confederate Constitution (see DeRosa 1991 and Holcombe 1992 for a description of the differences between the U.S. Constitution and the Confederate Constitution). Secession was a "revolutionary experience," but the Confederate government adopted the tactics, if not the doctrines of state socialism (see Thomas 1992, p. 65).

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The King Cotton embargo only added to the credibility and legality of Lincoln's blockade and lost the best opportunity to export cotton, establish credit in Europe, import war materials, and achieve recognition and support from England and France. Impressments of steam-powered ships in the Confederacy restricted blockade-running and privateering but contributed little to the effort for independence. Most importantly, the policy of impressments had a chilling effect on the supply of ships in the Confederacy throughout the rest of the Civil War. The Confederate States Navy ironclad-building policy did not contribute materially to lifting of the blockade and resulted in the rapid depreciation of the Southern railroad network.[45] Finally, the Confederate government imposed policies that greatly reduced the incentives for international trade, including tariffs, prohibitions on luxury goods and alcohol, trade regulations, and government cargo allotments on all private blockade-runners. The combination of these policies, which is by no means an exhaustive list of policies that harmed the Southern economy, created what was, in effect, a Confederate blockade of the South.[46]

Ironically, these policies are the same policies that many historians have argued would have produced victory for the Confederacy had they been pursued earlier and more vigorously. This article demonstrates that the economic theory of war did apply to the American Civil War and supports the overcentralization thesis of Stromberg and Hummel over the "traditional view" of Confederate defeat as merely a matter of who had the largest army.

It is important to note that the economic theory of war does not necessarily displace the historical explanations that rest on such factors as internal dissension, a failure of leadership or diplomacy, the demise of the railroads or the economy, or some combination of these factors. Rather, economic theory, properly applied, provides an approach in which all of these factors can be properly understood–each the result of interventionist government policy and each contributing to an understanding of the overall Confederate defeat.[47] In

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[45]If submarines such as the *Hunley*, which sunk the USS *Housatonic* off the coast of Charleston, South Carolina could have been improved and produced in sufficient numbers, the blockade could have been broken or sufficiently weakened to open international trade. The submarines were small, with no engine, and did not require large amounts of precious iron or labor. The strategy for the submarine was to break the blockade and open trade rather than protection of domestic manufacturing.

[46]We believe that Confederate government policy was the most significant deterrent to trade, but whether the Union blockade or Confederate policy had the greater effect is not material to the argument. The South lost a lot, but it did not lose by much.

[47]To put it in simple economic terms, economic theory has a comparative advantage in the description and understanding of causes while history has the comparative advantage in the description and recording of effects.

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addition, this article provides insight into how Confederate defeat might have been avoided had policy been pursued on the basis of the free-trade philosophy of the prewar South.[48]

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[48]Rather than extending the killing and suffering of the war, a laissez-faire approach to international trade policy on the part of the Confederate government might have shortened the war and reduced the amount of death and destruction. On the limited government philosophy of the founders of the Confederacy see Rable (1994). We have not explained the failure of the Confederacy to adopt this strategy or why it did adopt the failed ersatz strategy, but we do hope to address these issues in future research.

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THE UNEASY CASE FOR DEGRESSIVE TAXATION: A CRITIQUE OF BLUM AND KALVEN

MURRAY N. ROTHBARD

We must all be grateful to Professors Walter J. Blum and Harry J. Kalven, Jr. for providing in a brief space a cogent review and critique of the various arguments for progressive taxation, together with an extensive and valuable bibliography of the varying points of view. We must also be grateful to discover a serious monograph that rejects progressive taxation as such, although it does support a form of such tax which the authors label "degressive." Unfortunately, that is as far as one can go in granting this important article unqualified support. For its argument is shot through with errors and omissions that need to be carefully sifted from its valuable contributions.

A discussion of taxation is perhaps unique in that it involves fundamental problems in economic theory, political philosophy, ethics, and constitutional law. Taxation cannot be, or, at least, has not been presented as a pure economic problem; it has been tangled with problems of justice, politics, etc. In addition to its involvement in several social science and philosophic fields, it is by its nature a highly controversial field, especially when an author pronounces a value judgment on the type of tax which should or should not be levied. The entire existence and power of the State is wrapped up in the taxation question. It is therefore likely that any article in the field of taxation,

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EDITOR'S NOTE: Murray N. Rothbard (1926-1995) was the S.J. Hall distinguished professor of economics at the University of Nevada, Las Vegas. This is an unpublished manuscript from the Rothbard papers, written in 1952 for the Volker Fund. In a letter to the Volker Fund's Herbert C. Cournuelle, on August 18, 1952, Rothbard gave his reasons for writing about the Blum and Kalven essay: "[I]t is certainly an important one. . . . However, it is decidedly an article of mixed quality, containing many errors and significant omissions. Because of this, I am at present engaged in writing a detailed critique of the article." The article is Walter J. Blum and Harry J. Kalven, Jr., "The Uneasy Case for Progressive Taxation," *University of Chicago Law Review* 19 (1952): 417-520.

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especially when its facets have been traditionally treated fallaciously, is bound to be susceptible to numerous errors and pernicious judgments. This article is no exception, and its importance requires it to be measured in detail against the yardsticks of sound economic theory and individualist political philosophy, both of which are involved in the subject of taxation. Since the authors advocate a system of "degressive income taxation" (proportional income taxes above the minimum subsistence level), they leave themselves open to criticism in both areas.

First, in their discussion of progression the authors fail to consider any other tax than the income tax. The authors recognize that income is not the only base for tax rates: saying "either capital or expenditure could be used." And then they simply and dogmatically state: "The income base, however, appears to offer the best framework for analysis of the case for progression" (p. 419). On expenditures there is only a footnote declaring that a progressive tax on the consumption of milk would be "regressive as measured by income or wealth." Presumably this is enough to damn all further consideration of a spending tax. Indeed, on the same page, the authors make the usual arrogant assumption that "no one" could possibly favor a regressive tax structure.

> The rate of tax . . . may be graduated downward with income and thus be regressive; under this pattern a man with ten times the income of another would pay something less than ten times the tax. It is so clear no one today favors any tax because it is regressive. . . . A regressive tax on income is not a serious alternative.

This casual dismissal of regression is one of the major defects of the entire article. After brusquely dismissing regression, the authors quickly go on to another pernicious assumption: "It is almost unanimously agreed that some exemption keyed to at least a minimum subsistence standard of living is desirable." Again a spurious unanimity is invoked as a means of avoiding reasoned discussion. Such an exemption is by no means obvious; in fact, it is difficult to justify such an exemption at all. Why should the able be especially penalized,and the less able especially privileged? Suppose further the minimum subsistence level is $2,000, and the proportionate tax above the minimum is 20 percent. A man who makes $2,000 a year would pay no tax at all, while a man who makes $2,500 would pay $100. If we grant for the moment that governmental activities are worthwhile, then it is difficult to see why a man slightly above the minimum should subsidize government activities for a man slightly below the minimum.

Blum and Kalven admit that their proposed "degressive tax" (proportionate income tax above a minimum subsistence exemption) is in reality a form of progressive tax. Despite their attempts to distinguish between the two forms, and despite the lesser severity of this tax, the fact remains that Blum

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and Kalven's arguments against progressive taxation only result in their own advocacy of a form of progressive taxation.

A further result of minimum exemption–admitted by the authors–is that a tax-earner with a large family pays less than one with a small family–since the subsistence exemption is larger for the former. Under what principles of justice must bachelors pay to subsidize someone else's prolific breeding?[1] This injustice is part of the larger issue–that any compulsory tax of a more able group to support a less able and more "needy" group is pure highway robbery. It is highly significant that, in an article which devotes much attention to "justice," the robbery aspect of progressive taxation is only barely mentioned, and then in a very unsatisfactory fashion (see below). In the first part of the article dealing with objections to progressive taxation, this key issue is not discussed at all.

There is of course a further objection, which will be treated below, that there is no possible way of setting a "minimum subsistence level" except purely arbitrarily, and that setting exemptions at some other level, as the authors admit, merely brings the system right back to unadulterated progressivism.

With this inauspicious beginning, the authors set out to examine the arguments against progressive income taxation. They begin with the constitutional argument. Here the sound constitutional objections to a progressive income tax are rudely brushed aside. As in other cases, the authors' review of the history of the subject is useful and interesting, but the position that they uphold is the wrong one. They sneer at the great *Pollock* decision of 1895, that the income tax is a direct tax. Of even greater importance is the great argument of Justice Field, which they quote, that any progressive or degressive income tax law violates the constitutional clause requiring *uniformity of tax* and also violates the Fifth Amendment's due process clause. The authors recognize that the adoption of the Sixteenth Amendment by no means disposed of the constitutional issue, since this amendment did not supersede the uniformity or due-process clauses. They recognize the enormous ignorance of Chief Justice White's *Brushaber* decision in 1915, which validated the income tax law on erroneous grounds, and which has never been added to or challenged thereafter. Yet, despite this, and despite Hackett's brilliant arguments attacking the constitutionality of progressive or degressive taxation, the authors simply conclude in one of their offhand statements: "the result seems clearly sound on constitutional grounds" (p. 427).[2]

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[1]Such a subsidy aggravates its own problem, and becomes self-cumulative, by encouraging larger families among the poor.

[2]This section gives interesting legal references for and against the constitutionality of

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Blum and Kalven next launch the body of their article devoted (a) to general objections to progressive taxation, and (b) to the arguments in its favor.

In the objections to progression, they fail to mention one of the fundamental ones–that is unjust highway robbery, especially flagrant since they deal with questions of justice in the course of the discussion.

The first objection they consider is administrative complications. The authors endorse this objection, and there is little to add to their discussion.

The second objection considered is the basic one that under it a majority can use their ballot power to confiscate the income of a minority, a power limitless under progressive taxation. Blum and Kalven brusquely dismiss this valid objection by merely saying that "majority rule . . . is superior to any other principle for resolving group decisions." And not to agree with this preference for majority rule "is to reject democratic self-government." This is simply a sneer. In the formal sense, all government rests on majority consent. However, to protect the rights of the individual, general and prior majority consent to a rigid constitution that severely limits the powers of government is a far better guarantee than constant reliance on the good sense and discretion of the elected "people's representatives." If this is antidemocratic, so much the worse for "democracy." In a footnote, Blum and Kalven make their argument absurd in their attack on the antiprogressive argument of W.D. Guthrie, by asserting that Guthrie's fears of confiscation "have not been realized in practice" and that these are "fanciful dangers." Their argument consists of an extended quote from Seligman: it is perhaps excusable for Seligman to have made these remarks in 1909, but for Blum and Kalven to rely upon them in 1952 flies in the face of the confiscation ruling in the world today.

Their hopeful citing of the Knutson tax reduction of the Eightieth Congress as an example of the majority's ruling reducing taxes clearly backfires; this "reduction" was a piddling one, and was quickly reversed. The fact that the authors favor restrictions on the majority in the area of free speech and religion makes incomprehensible their accusations of "antidemocratic" against those who wish to place further necessary restrictions on government.

The third objection to which they turn is a crucial one–that the progressive income tax destroys the capital structure and the standard of living of society. Here, Blum and Kalven do a truly abysmal job. They claim that the effect is really "in the realm of conjecture in psychology," and attempt to use

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progressive taxation, such as the Hackett article. They summarize the arguments on state progressive inheritance taxes, without taking sides, but it is clear to this writer that Justice Brewer's dissents on the basis of uniformity and violation of the Fourteenth Amendment, destroying all progressive taxes, were magnificent. The majority decisions by Justice McKenna and Chief Justice White are clearly sheer sophistry. We shall also be interested to read what the authors call one of the most bitter attacks ever made against progressive taxation–the article by David Ames Wells in the 1880 *North American Review*.

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the fact that low taxes are better than high taxes to absolve progressive taxation from the guilt involved. They soft-pedal the effect of progressive taxation on incentives to work with the canard that money only really matters "as a symbol of prestige or success," and that, therefore "Progression does not impair this incentive since the highest income is still the highest income both before and after taxes however high the marginal rate of tax." They quote with approval the ridiculous assertion of Simons that "our captains of industry are mainly engaged, not in making a living, but in playing a great game." Furthermore, they even give credence to the notion that the higher the tax rate, the greater the incentive to work in order to maintain the "net position after taxes."

On the effect of progression on capital formation–a key consideration–they are equally unsatisfactory, backing and filling between the different positions. At one point they will recognize the destructive effect on capital, and a few paragraphs later, they vitiate with doubts, uncertainties, and such inane remarks as the following: "And it may well be that a sufficient group in the society will be disposed to gamble whatever the odds"; "It cannot be taken for granted that the discouragement of the most risky enterprises is, at our present level of technological development, an unqualified evil"; and "It seems equally plausible that the lower effective rates (of return on savings due to a progressive tax) will induce some persons to consume less now and to save and invest more in order to maintain their incomes after taxes at desired levels in the future."

Blum and Kalven conclude by deciding that the effects on capital and work are merely "highly indeterminate." They go on to insist that even if the effects are to destroy capital, "it would take an extremely drastic rate of progression and very high taxes to endanger the existing accumulation of capital," as if the present rates are not drastic! And if it merely restricts further growth of capital, after all, "at some point it is reasonable to question the wisdom of society in always continuing to postpone present consumption for the sake of greater consumption tomorrow." They deprecate the objections to progression on these grounds offered by Lutz and Jundson, and cite favorably such absurd arguments as Simons's that the "cost of our present stock of productive instruments was . . . decades and centuries of terrible poverty for the masses," and Edgeworth-Pigou's that enforced equality really "increases productivity" because of the "improved morale" of the poor, etc., etc.

Blum and Kalven conclude this most unsatisfactory section (pp. 437-44) by asserting that productivity, even if it were clearly injured by progression, is not overriding, because a tax system promoting savings would be "a regressive tax system" which they blithely consider unjust without further discussion. It is interesting to note here that Blum and Kalven add a footnote dealing with Beale's (and Fisher's) suggestion of a progressive spendings tax as a way of keeping progression without impairing capital.

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Instead of coming to grips with this issue, they merely dismiss the spendings tax (even a progressive one) by saying: "Such a tax would inevitably be somewhat regressive at the higher levels of the income scale."

The net effect of Blum and Kalven's backing and filling on this issue is to dismiss this objection to progression. They conclude this part of the discussion with a quotation from Simons. They cite this quotation with approval, but it is so bad that it deserves quoting at length:

> If we deliberately limit the degree of progression, out of regard for effects on accumulation [of capital], we are in effect removing taxes from those who consume too much and transferring them to classes which admittedly consume too little; and against the additional capital resources thus painfully acquired are mortgages, property rights, in the hands of those freed from tax. While the saving will really have been done by those at the bottom of the income scale [presumably because they have abandoned progression for proportionate taxation], those free from tax and their assigns will enjoy the reward. This method of fostering increase in productive capacity thus increases the concentration of property and aggravates inequality. . . . [T]he scheme looks a bit like taxing small incomes to reduce consumption in the hope that those relieved of tax will save more after consuming all they can, and then allowing 1 per cent to those who have really done the saving and 4 per cent to those who have served merely by paying smaller taxes.

It is not surprising that the authors conclude by stating that the objections to progression are "far from conclusive."

Having begun the article by basing their discussion on several fallacious assumptions, Blum and Kalven treat the case against progressive income taxation in a manner which ranged from omission of important elements to confused backing and filling to outright acceptance of fallacious and antifree-market arguments. The valuable parts of the article so far (some biographical references, historical sections, and treatments of administrative confusion due to the tax) have been so brief as to be overshadowed by errors.

Blum and Kalven next turn to the major part of their article: a critique of the arguments for progressive income taxation. They turn first to the argument that this type of tax helps maintain a high, stable level of economic activity. One such approach is that of Mints-Friedman-Simons, who hail the fluctuations in income tax receipts with changes in economic activity. A progressive tax increases the effective tax rate under inflationary conditions and reduces it in a depression. Blum and Kalven unfortunately agree that "there is now general agreement that it is altogether appropriate for the government deliberately to operate with an unbalanced budget whenever significant inflation or deflation is taking place"; that is, to have a surplus in a boom and a

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deficit in a depression. Blum and Kalven obviously support this fallacious point of view, but are inconclusive on this argument, inferring that the progressive features of the income tax law does not add so much to this feature that it cannot be eliminated.

The second such approach is the Keynes-Hansen mature-economy approach, which supports progressive taxation in order to boost consumption as compared to savings. Their critique of this approach is rather weak; they do not point out that depressions are never caused by "under-consumption," and therefore cannot be relieved by such measures–quite the contrary. Their main argument is that stagnation does not exist so that such a remedy need not be adopted. Finally, they advocate, to counteract temporary depressions, lowering taxes uniformly while maintaining government expenditures. Thus although some of their criticism of the Keynes-Hansen position is valid and useful, it is unfortunately weakened by various concessions.

Having thus disposed, though not very decisively, of the stability case, the authors turn to the taxation arguments based on justice. There are three criteria or principles to use as bases for levying taxes: benefit received, costs incurred, and ability to pay.

They first turn to the benefit principle–that people should pay taxes to government in accordance with the benefits they receive from government. The benefit principle is not a wholly satisfactory one, but it has much merit, especially as compared to the "ability-to-pay" doctrine. According to this theory, for example, the users of roads are taxed on their gasoline purchases in order to pay for the upkeep of roads. The authors seem to favor benefit taxation in many cases, such as these, where the benefits may easily be traced. In such cases, however, it is difficult to understand why (assuming the government should operate them at all) these services should not be *priced* and have their expenses paid solely by their customers. Thus, the users of the post office should be the ones to pay for the service, the users of parks to pay for the parks, etc.

Blum and Kalven next proceed to those expenditures where benefits allegedly cannot be definitely traced. Here they are at their best in destroying the fallacy that benefits to property owners increase either proportionately or progressively with the value of property protested (pp. 452-53). This "benefit" argument for progressive (or proportionate) income taxation rests on the fallacious "tax as insurance-premium analogy." They point out that such property-protecting outfits as police, army, and fire fighting, do *not* benefit the owners of property according to its value, and indicating particularly that owners of intangible property benefit far less than owners of real estate. Furthermore, they agree that the services of government in defense of persons is alike for all individuals, and add that the amount of police and army necessary to protect persons are probably adequate to protect property as well.

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Yet, inconsistently, Blum and Kalven approve of Mill's attack on a proposal for equal poll tax on all persons and a proportionate tax on property, which stated: "it is not admissible that the protection of persons and that of property are the sole purposes of government. The ends of government are as comprehensible as those of the social union"–the authors add that mere protection is "only a small fraction of the total services performed by government" in a "modern state." But this is just the point. Individualists believe that this is the maximum of service that the government should bestow–that this is the only field where government is competent to perform service, and the only field in which justice permits the government to be active. By adopting Mill's vague statist criterion instead, they abandon individualism, and they abandon the only field in which government–the organization of force–is competent; instead they adopt the philosophy of collectivism.

Blum and Kalven dispose of the very useful "cost principle" in a footnote: "sometimes the theory is stated in terms of the *cost* of the government services performed for each citizen rather than in terms of the *benefits* received from such services." The authors' only comment is, "This refinement may avoid the need of measuring subjective benefits, but it does little else for the theory." This is their sole comment on the *cost principle*. Yet the cost principle is very different and far superior to the benefit principle. In the first place, it is a great advantage that it does not have to measure subjective "benefits." Benefits are purely subjective, and can never be measured, and the fact that some of the best parts of this article are devoted to criticizing "equal sacrifice of utility" theory precisely on this ground makes it even stranger that the authors did not examine the cost theory in more detail. Indeed the impossibility of measuring benefits is also a strong argument against the spendings tax mentioned above, since money-expenditures are not a criterion of psychic benefits.

The cost principle levies the tax on the most accurate estimate of cost of the operation to the government. Services such as the post office, for instance, would be priced on the cost principle, although individualism would eliminate these wasteful, monopolized services entirely. The police-army services of defense of person and property would obtain its revenue (a) from fines on wrongdoers, and (b) from taxes according to cost levied as equal poll taxes on each person under protection; and approximately proportionate to acreage on real property policed. All services on the free market are priced according to marginal utility (which, in turn, sets costs); if it is just for *all* consumers, regardless of wealth or income, to pay *one price* on the market for all these services–food, autos, etc.–why is it not just for all receivers of government protection to pay equally for the same service? Since there is no free market for protection service, a tax levied on the basis of cost is the best approximation to the free-market ideal of one good, one price.

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Furthermore, the benefit principle has the unjust feature that those who benefit more must pay more; why should a man be punished because he is happier? The cost principle–based on equal price for equal service–voids this problem.

In the course of their keen analysis of the benefit principle, the authors successfully attack all phases of the benefit arguments for proportion and progression. As a matter of fact, they point out, with Mill, that the poor and the unpropertied probably benefit more heavily from government police protection than the rich, who could pay for their own private protection. "If there were any justice, therefore, in [the benefit principle] . . . those who are least capable of helping or defending themselves, being those to whom the protection of government is the most indispensable, ought to pay the greatest share of the price." Thus, under the benefit principle, a poor man would be taxed more heavily than the rich. The cost principle is not open to this objection–since it taxes absolutely equally for any service rendered, regardless of the subjective benefits rendered to each of the consumers.

Blum and Kalven add with horror that the benefit principle would require the specially privileged "underprivileged" who receive welfare subsidies from the government to be precisely the ones to be taxed for their payment. On the contrary, here is one case where the rigorous application of the benefit principle would quickly end agitation for these statist schemes.

Thus, Blum and Kalven retain the benefit principle only where benefits are directly traceable, and the benefits are not "a consequence of deliberate welfare measures." On the contrary, the benefit principle should be retained only in cases of "welfare measures" and all other subsidies to specially privileged groups.

The authors' section on the benefit principle thus contains much keen analysis, but is vitiated by concessions to collectivist and "welfare" philosophy and neglect of the cost principle.

Blum and Kalven next proceed to the "equal sacrifice" criterion of taxation. They make the interesting assertion that this approach treats taxes as though they were a confiscation of property, and "the problem then becomes one of confiscating in an equitable manner." Since this approach toward taxation is quite realistic, it is unfortunate that Blum and Kalven did not raise the obvious question at this point: Why assume that there can be such a thing as "confiscation in an equitable manner"? If taxation confers no benefit, why tolerate taxation at all?

It is clear that this assumption places the entire "equal sacrifice" theory in a highly curious position, and although Blum and Kalven do not pursue this position, it is one of their great contributions that they highlight the fact that "sacrifice theory"–which has loomed the largest by far in all discussions of taxation–rests basically on this taxation-as-harm assumption. As they put it,

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"An equitable apportioning of sacrifice requires inflicting equal hurt on each taxpayer." To a thoroughgoing individualist and libertarian, this basic goal of the sacrifice theorists reveals the utter absurdity of their position. Instead of worrying about what constitutes "equal hurt," why inflict any hurt at all? Why tolerate an institution that represents only pain and injury, and then try to find some sort of "equitable means" of spreading it around? The entire concept of "just and equal" in suffering is an absurdity.

Setting aside this point for the moment, we return to Blum and Kalven, who proceed on a lengthy and generally very valuable analysis of the various attempts at measuring "equal sacrifice." This is generally an excellent section and provides valuable analysis and bibliography of the different points of view. This is probably their outstanding contribution.

They analyze the "utility curve" of money and its components, and clarify the different contentions. Best of all, their final devastating attack on the whole "utility of money" analysis as a basis for taxation rests on the Mises-Robbins contention that utility cannot be measured, and therefore cannot be compared between one person and another. They recognize that utility is an ordinal concept, and that therefore "the whole elaborate analysis of progression in terms of sacrifice (disutility) and utility doctrine finally collapses." (It is unfortunate that this conclusion is marred slightly by an absurd footnote quotation from Pigou attempting to deny this.) They point out the analysis rests on an attempt to measure utility and disutility by the amount of money income, and to compare diminishing marginal utility of money between persons.

Their main error in the course of this sacrifice analysis is their preference for the "proportionate sacrifice" standard over the "equal sacrifice" standard, although it is one of their great merits that they have brought the distinction between the two concepts into clear focus. They prefer the former (although finally discarding both) because the latter is "regressive" in income taxation, although most economists have preferred the equal-sacrifice principle. If we assume for the sake of argument that utility can be measured in units, and compared between persons, the equal-sacrifice formula states that each individual should give up an equal *percentage* of his total utility derived from money. It should be clear to all that the former is more just; at least it preserves some sort of equality before the law that is a requisite of individualism. The proportionate criterion is the reverse of justice; why should one man sacrifice more units of utility just because the market has made him richer than the next man? This is clearly unjust discrimination and confiscation of the rich. Yet, Blum and Kalven reject the equal-sacrifice principle because it is regressive; a man with $10,000 income would pay more than a man with a $5,000 income but *less* than twice as much. This is all part and parcel of the authors' continual preference for proportionate taxation and horror of equal taxation or "regression."

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In the course of this discussion, Blum and Kalven advance their only argument for the proportionate formula in general—that it is "neutral" as compared to the distribution on the market; all people are equally worse off as a result of the tax. And they indicate on page 461 that their rejection of proportionate sacrifice on grounds of immeasurability of utility leaves them with proportionate income taxation on grounds of its "neutrality." The question arises: Is a proportionate income tax best because it is neutral with respect to the market?

At first blush, this argument is superficially appealing. If a tax of 10 percent is levied on all incomes, is not the market distribution left untouched? Each has 10 percent less income after taxes than before. This argument, however misinterprets the nature of the market and "neutrality" toward it. The question should be: How are all prices of goods set on the market? They are set on the basis of one price for each good, *regardless* of the incomes of the people on the market. A pound of butter costs the same to a poor man as to a rich man. Yet this one-price system is considered just, especially by writers like Blum and Kalven who claim to support the market process. It would be considered unjust, and rightly so, if the rich were penalized for their wealth by being forced to pay more for every service than a poor man. Equal price for equal service—discrimination against neither rich nor poor—is the rule on the market. Therefore, if it is the rule of justice to be neutral with regard to the market, then taxing will take place as nearly as possible on a *market basis*; it too would *tax each person equally*. If the government taxes the rich more heavily—in amount not in "proportion"—than the poor, it is not being neutral; it is introducing a principle of charging, which is foreign to the market.

There are several gems of analysis contained within Blum and Kalven's critique of sacrifice theory. There is the "customary sacrifice" contention of the Stamp which highlights the impossibility of measuring subjective sacrifice; and there is the greater chance of going wrong under progression; there is excellent critique of the Pigou argument for progression based on conspicuous consumption. The authors demonstrate that this Veblenian evil is likely to be more widespread among the middle classes than among the "rich."

A third type of sacrifice theory which the authors analyze is the "minimum social sacrifice" theory of Bentham and others. This assumes some sort of "maximum quantity of social satisfaction," and, of course, makes the same error in assuming measurability of interpersonal satisfaction. The minimum social sacrifice doctrine is, of course, completely vicious—it disposes of all equality before the law or neutrality concepts—and demands what amounts to outright leveling of incomes and confiscation of higher income groups and subsidizing of lower income groups. Aside from considerations of justice or productivity, the fundamental criticism is that sacrifice cannot be measured between persons by simply comparing income. Furthermore, the utilitarian

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principle of minimum sacrifice assumes that it is the state's function to allocate happiness between persons, which would be vicious even if it could be accomplished. The authors rightly footnote Simons's remark that on the minimum-sacrifice doctrine, those with a greater capacity for pleasure would be taxed less than others–a curious doctrine to say the least. The authors' rejection of the formula, however, is not as strong as it might have been. They concede too much to its being a "variant formulation of the question for the common good or the common welfare."

In the general argument against a measurable diminishing utility of money, the authors are wrong in indicating that the utility of money does not really diminish. It does diminish as the stock increases, but the crucial point is that this decrease cannot be measured, and here the authors are correct.

After disposing of the sacrifice theories, the authors turn to the next principle of taxation, the "ability to pay." They point out correctly that, in general, the term "ability" is simply the converse of the sacrifice doctrine, *the ability to bear a sacrifice*, which also cannot be measured. Again, however, their treatment is marred by an acceptance of proportionate income taxation as being properly commensurate with ability to pay. The authors fail to proceed further to a critique of the ability-to-pay principle itself. This "principle" is simply that of the highway robber, who takes as much as he can. It is a curious form of "justice" for the state to pursue in taxation.

Blum and Kalven are at their best in an excellent critique of the Seligman argument for progressive taxation, based on the absurd theory of "faculty" of earning money. They also have a fine critique of Hobson's proposal to tax "surplus" economic rent, and of Peck's peculiar plan to tax consumer surplus.

The authors next have a fine critique of the "moral consumption" ideas involved in arguments for progression.

Finally, Blum and Kalven turn to consider the argument that progressive taxation is good simply because it brings about greater economic equality this is the Henry Simons position. If egalitarianism should be pursued as a policy, progressive taxation is one way of achieving the goal. The authors assert that if Henry Simons rests his case simply on a value judgment that equality is good and is an ultimate one, there can be no further discussion. They fail to recognize that the infinite variety and inequality of talents among human beings makes the goal of egalitarianism absurd and antihuman, better suited to an ant-heap than to human society.

In treating the socialist-communist arguments for progression, it was not necessary for Blum and Kalven to levy an implicit insult on Lutz and Crotty for maintaining that advocates of progressive income taxation are unwitting collaborators of socialists and communists. This charge may not be pleasant, but it is true, and it is out of order for the authors to call this "the rhetorical possibilities of guilt by association" (p. 489).

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Passing over the socialist and the Simons position, the authors ably point out that the case for equality rests at bottom on sheer envy, is certainly a gross injustice as a foundation for political policy, and state that envy can certainly not be eliminated even by enforced equality.

Blum and Kalven then keenly examine the "general welfare" argument for progressive taxation. They point out brilliantly that (a) welfare can no more be measured than utility or sacrifice, and that (b) even if it were such taxation would benefit one group at the expense of another, and that, therefore the welfare considered *not* general, but special. The authors also point out the difficulty that the egalitarians have with the government–shall the confiscated money be spent by the poor or by the government? Increase in government expenditure may be highly undesirable and lead to a loss in consumer freedom.

The authors next have an excellent critique of the "democratic" argument for equality. This is the Tawney-Lasswell contention that democracy cannot work well if incomes are too unequal, and equality will ensure against revolution. Against this familiar theme song, the authors set: Edgeworth's observation, that there may be more danger in whetting the appetite of the poor and thus precipitating revolution, aside their own contention that the money route to political power is far better than status-routes dependent on heredity, caste, and military prestige. Here the authors rely also on some apt statements by Wright. They also dispose rapidly of the inane "money power" and "private sovereignty" arguments against the rich.

Finally, the authors dispose in admirable fashion of the "moral reform" argument for equality, based on the "sense of fellowship" that would ensue. Rivalry would only be shifted to other, more unpleasant areas. The argument could be much stronger here, however; money differences in the ultimate analysis are the main thing that binds man in a sense of fellowship rather than the reverse. These money differences arise from the peaceful cooperation of the market, and it is only as a result of such peaceful cooperation, as Mises has brilliantly pointed out, that any sense of fellowship can emerge. The authors are to be commended for their footnote by Sharp that a sense of fellowship through equality can be highly dangerous and lead to rule by dictators and mobs.

Blum and Kalven conclude by denying that economic inequality is in itself a good, and assert that past arguments that a wealthy group is needed to be the culture bearers of society are now outmoded by universal education. We must differ strongly; universal education has in fact led to a general degradation of cultural and educational standards. It is still true that only a small elite are culture-carriers; although the spread of universal education has made this elite harder to distinguish and to discover. This elite is certainly not identifiable with the wealthy; but it is still true that the wealthy are far more likely to recognize and patronize the elite than are the masses.

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Having disposed of the case for economic equality, the authors return to the other side of the coin—the question of whether or not the market's income distribution is a just one. If it is, then the perniciousness of attacking the unequal distribution of income resulting from the market is evident.

The authors first ably point out that even if there is underserved income on the market due to monopoly and fraud, there is no correlation of *undeserved* income and *total* income and therefore no case for progression. The authors err seriously, however, in (a) attributing monopoly to the market—undeserved monopoly income is attributable to state deviations from the market; (b) treating fraud and duress as part of the market—these too are anti-market phenomena and are illegal; (c) treating shifts in the value of money as causing unjust income rewards—this is only another market phenomenon and no more unjust than any other change; and (d) treating luck as leading to "undeserved income." In the first place, luck cannot be legislated, and second, it is usually the able and enterprising that can take advantage of the luck that comes their way. Each person is equally liable to be confronted with good or bad "luck."

Having disposed of the unjust reward argument, Blum and Kalven do a very fine job in probing further the arguments of the anti-inequality writers. They show that some really base their position on abandonment of all personal responsibility. In this amoral and monstrous view, the able are not to be rewarded because they are not responsible for their talents, and the criminal not to be punished for the same reason. Upheld consistently, this view is anti-human and anti-individualist in the deepest sense. Blum and Kalven do well to attack this deep-seated modern doctrine.

Also, they show that it is nonsense to use the fact that modern production requires division of labor and cooperation to say that therefore no one's rewards can be separated from another's. The authors point out rightly that this separation is precisely what the pricing process accomplishes.

In their final argument, Blum and Kalven consider the argument that the market, in dispensing monetary rewards, does not rate "the whole man," and that perhaps the state should redress the balance. Here, the authors are curiously inarticulate. They merely state that this argument is rarely formulated. They admit in a footnote that the market is not the only rewarder in society, that, for example, there are nonmonetary markets such as friendship in exchange for praiseworthy qualities, which appraise these other qualities with which the market is not concerned. Yet they seem to favor this argument by implying that the progressive tax provides a useful method for society to review and change the market's distribution of income. The market's rewards are monetary for contributions that can be appraised in terms of money; what justification is there for the state to alter this monetary pattern? If market monetary rewards are just, as Blum and Kalven admit, the contention that

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they still should be "reviewed" through progressive taxation is an absurd one. Yet, nonmonetary contributions continue to be rewarded in nonmonetary ways.

Thus, Blum and Kalven began their article unfortunately. Each of their basic assumptions was fallacious, and their treatment of the arguments against progression unsatisfactory. However, we have seen that the great value of their article lies in most of their critique of the arguments for progression—particularly, the sacrifice, ability, and equality arguments. Much of their analysis in this part is of a high order. The merits lie, however, not in any arguments for "degression" but in the arguments against progression.

It is unfortunate that, after concluding the critique of arguments for progressive taxation, the authors should slip back into much fallacious argument in their discussion of "equality of opportunity" and inheritance.

They first make the flat statement that rewards cannot be considered just "unless the contestants start from the same mark," and they continue with a quotation from Tawney that the "game" is not fair "if the rules of a game give a permanent advantage to some of the players." Also, equal opportunity will develop individual talents best.

This position completely misconstrues the nature of the market and of society generally. Blum-Kalven-Tawney err in considering human life and action some sort of "race" or "game," where each should start in an identical position. Life is not a race, but an attempt by each individual to be as happy as possible. Since the world has not just come into being, it is absurd to decree that everyone should "start" the same. Each individual's "reward" for his industry, foresight, and saving consists of property which it is his right to dispose of as he sees fit. This disposal includes, certainly foremost, the right to accumulate and give to his children. It is an absurd and pernicious doctrine of "justice" that each child should "start" absolutely equally. It is an anti-human position, since each child manifestly begins completely unequally—with unequal abilities and parents. If parents have a right to beget and raise children without state interference, then parents have a concomitant right to provide that environment, and that amount of money for them, that they think best. To provide "equality of opportunity" in the sense of equality of infants would have to mean that the state nationalizes all infants and raises them in State nurseries under precisely "equal" conditions (although, even here, absolute equality is not possible). If private raising of children is admitted, then private inheritance must also be fully admitted.

Blum and Kalven penetrate to the issue by stating that the "important inequalities of environment, in its broadest sense, are for the children." They

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proceed to endorse inheritance taxes, and go on to restate the old canard: "Today few dispute the force of the equalitarian case in this context." As one of these "few," we reiterate that if freedom for the private family is accepted and the horror of communication of children squarely rejected, there is no case whatsoever for inheritance taxation or "equality of opportunity" in this field. Blum and Kalven do not improve matters much by conceding that this "strong" argument for progressive inheritance taxation must be "counterbalanced" by considering the impairment of incentives to work and disruption of the family standard of living.

The authors merely conclude that the case for progressive inheritance taxation is pretty well established, but not progressive income taxation, and bolster themselves by citing a "tradition" for this program (Hill). On the contrary, a progressive inheritance tax is far worse than progressive income tax. As the authors skim over without pointing out its significance–the inheritance tax is a *pure tax on capital.* It does not tax income at all. It is a pure tax on accumulated capital, and thus leads directly to impoverishment. Not only that, but it is a pure tax on that very form of endeavor that provides the main incentive for long-range accumulation of capital after a man's death–the bequest to one's children. It is therefore a staggering tax on capital. Not only should there be no progressive inheritance tax, there should be no inheritance tax at all. An inheritance tax is pure evil, and no valid arguments can be found for it.

The authors err fundamentally in believing that inheritance leads to a "permanent" handicapping, or inequality of the "rules." Inheritance of wealth is not permanent at all. In contrast to inheritance of status–aristocratic, military, bureaucratic, or political–inheritance on the market is precisely always in danger of being dissipated if the heirs are not careful. Every inheritor must continue to invest profitably not only to increase his wealth, but to maintain it. George Washington was one of the wealthiest men in the America of his day. A few generations later, the Washington family disappeared from the scene.

But for Blum and Kalven an inheritance tax (progressive) is not enough in reducing "inequality of opportunity." For before inheriting the money, the children receive the benefit of parental expenditure on them. Here is a critical loophole indeed. As the authors put it:

> The critical economic inheritance consists of the day-to-day expenditures on the children; it is these expenditures which add up to money investments in the children's health, education and welfare which in the aggregate are . . . gravely disparate.

There is a hint in a footnote that the authors would endorse a system whereby children would be taxed (in practice, of course, the parents) for the

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"income" (in goods) received from the parents, or the parents would suffer a stiff gift tax on all expenditures made for their children.

Fortunately, however, Blum and Kalven stop this process of reasoning in time to see where it leads. They (inconsistently) begin to draw back from the prospect of steeply progressive income taxes in order to equalize expenditures on children. They seem to look with favor on equalizing opportunities for "formal education, healthful diet, and medical attention" (p. 504), presumably by having the government nationalize these services and providing them equally. There still remain inequalities of cultural education and psychological training that seem unavoidable. At least the authors realize that attempting to remove all inequalities by tackling these areas would lead to complete destruction of the private family. As they put it, "this would call into question the very having of children." Yet they do not follow this thought consistently, but only continue to wrestle with the problem in confusion.

Blum and Kalven summarize by declaring, that for adults, enforced equality rests simply on envy, but "in the case of children these difficulties (in the arguments for egalitarianism) largely disappear. There is an enormously strong ethical claim to equality for the sake of children. What may reduce to envy as among adults surely is justice as among children."

Yet the authors are troubled by what will happen to the family and to private property under such a regime. Also, they realize the important point that if the conditions of children are equalized via progressive income taxation of the parents, then the later incomes of these children when grown up will also be subject to leveling, and "they will be denied the opportunity to enjoy the differential rewards which they have earned." In effect we would be first making certain that the conditions for the race are fair and then calling the race off. Precisely, and this should reveal the absurdity of "equalizing opportunity" to begin with. The authors thus conclude this section in a state of confusion.

Blum and Kalven conclude the discussion of equality with two erroneous footnotes. One purports to refute McCulloch's objection to a progressive tax that it renders the rate pattern arbitrary and uncertain. If the argument is on the merits of equality, then the progressive tax resulting, they claim, will simply be the result of "democratic debate." The fact that something is resolved "democratically" does not make it any the less arbitrary or capricious—indeed, it is likely to make it more so—or undo the harmful effects of such capriciousness. "In the end the distrust of progression on grounds of the uncertainty of the equality standard is only a doubt about the wisdom of entrusting the question of economic equality to the democratic process." Once again, we react to the invocation of the god Democracy, by saying "precisely"—let us see this question removed from the area of the democratic process and prohibited to government by constitutional means.

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Another error they make is to pooh-pooh the antiprogression argument that complete leveling will really add little, quantitatively, to the income of the mass of people even in the short run (i.e., aside from effects on productivity and capital). It is true that this algebraic argument has been overworked by opponents of progression (it is interesting that this argument is the central one in Bertrand de Jouvenel's recent *Ethics of Redistribution*), but after all it has its place and is not to be dismissed so brusquely. Its "cold mathematics" are *not* irrelevant to the agitation for economic equality–for it reveals some of the absurdity of the agitator's passionate pleas for redistribution. And the authors' contention that the quantitative benefits could really be great by "distributing the benefits in the form of community expenditures rather than cash" is singularly unconvincing, especially in light of their own doubts about state (not "community") expenditures and restrictions on consumer freedom.

Except for a brief concluding section, the remainder of the article deals with the Blum-Kalven case for "degressive" taxation–exemption up to the "minimum standard of subsistence" and a uniform proportionate rate above that. There is not too much of interest here. They explain that the degressive tax is progressive, but more mildly so than other types of progression. The outcome of their case is not favorable for degression even on their own grounds. They admit that if the exemption is set above the subsistence level, the progression will be far steeper, and explicitly graduated rates are likely and probable if such criteria as "decent standards of living" are set as the exemption. Their arguments against degressive taxation at high exemption levels are good, and they also have an interesting argument about the ambiguity of graduated rates in their comparison of the income-classes that are being leveled.

The authors conclude that degression would be worse than graduated progression if the exemption of the exemption level were set at a high level, and that graduation would also be necessary if the exemption level were too low, in order to soften the impact on the poor. Even on their own grounds, therefore, degression is only called for if the exemption level is squarely set at the minimum subsistence level. Yet, it is impossible to set such a level scientifically; any such exemption level would be arbitrary and subject to the further capriciousness of the authors' "democratic process." On the authors' own terms, then, their case for "degressive taxation" evaporates.

Why have exemption anyway? The authors present their brief position on page 509. One argument is the diseconomy of collecting small amounts of tax from many low incomes–this is totally unconvincing considering the "untapped resources" from the many low incomes. A second argument is the futility of the state's giving welfare benefits and then taxing them away–on the contrary, this is a cogent reason for not permitting exemptions, since this will be likely to end the welfare benefits. A third argument is the alleged "disadvantages of anchoring judgments about tax rates and government expenditures

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to the capacities of the poorest members of the community" (p. 509). On the contrary, this is a great advantage. A firm anchoring of this sort will ensure a very low level of state taxation and expenditures—precisely what is needed.

Blum and Kalven conclude with a discussion of government expenditures. Where benefits are traceable, though unintended, they advocate taxation of the recipients of the benefit. In discussing expenditures where benefits are not traceable, such as military or other defense expenditures, the authors realize that since we might roughly say that such expenses benefit everyone equally, the benefit principle would lead to *equal taxation.* They recoil with horror from this because it would increase economic inequality, and it "certainly is intolerable to predicate it [a case for increasing economic inequality] on the cost of the indispensable activities of government." But this is completely beside the mark; equal taxation is not a deliberate enforcement of greater inequality, any more than a grocer's charging one price for butter causes "greater inequality" between the rich and poor buyers.

The authors would also pay for welfare expenditures by degressive taxation. But it would be better to apply the benefit principle strictly, thus quickly ending such expenditures. This aim of reducing such expenditures is not entirely out of place here, since the authors admit that ending progression probably greatly reduces such expenditures.

I have engaged in this lengthy critique because the article is an important one. Professors Blum and Kalven have written one of the few scholarly attacks on the theory of progressive taxation in recent decades. They deserve commendation for their effort and analysis. In general, their article has been found to be strong in critical analysis of progression, but weak and confused in their positive recommendations and erroneous in attacking many anti-progression arguments.

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YES, WE HAVE NO CHAFF: A REPLY TO WAGNER'S "AUSTRIAN CYCLE THEORY: SAVING THE WHEAT WHILE DISCARDING THE CHAFF"

WALTER BLOCK

Richard Wagner (2000)[1] is an attack on the Austrian business cycle (ABC) theory. Although I shall be defending the latter against the former, I welcome Wagner's contribution to the debate on the Austrian theory of the business cycle.[2] It provides a good background review, and provides us with an opportunity to further elaborate upon and clarify the theory.

CHAFF

Not mincing words, Wagner charges the Austrian business cycle with "obsolescence," and describes it as "incoherent." What is the reason for this denunciation? It is obsolete, he says, because

> The Mises-Hayek exposition of the cycle reached its final form in the mid-1930s, and contemporary expositions have been predominatly restatements. Both economic theory and the institutional arrangements within

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[1]The article is found online at www.gmu.edu/jbc/fest/files/wagner, thus page numbers in quotes are omitted.

[2]For a rather hysterical critique of ABC theory, see Yeager (1986, p. 378), where he describes it as "an embarrassing excrescence." For an even more overwrought treatment, see Cowen (1997). Other critiques of ABC theory include Tullock (1987, 1989), Friedman (1969, 1993) and Hummel (1979). For rejoinders to the first two, see Salerno (1989), and Garrison (1996), respectively. See also Garrison (2000) and Cwik (1998).

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> which economic life is organized have changed greatly during the intervening years, and these changes pose challenges for several of the specific contours of Austrian cycle theory. With respect to institutions, the gold exchange standard has given way to a purely fiat standard. . . . a variety of occupations and businesses have arisen that specialize in forecasting the timing and extent of all kinds of governmental actions, including those of the central bank.

It cannot be denied that institutions have changed during these seven decades, but to think that this would call for an alteration of a praxeological theory[3] is surely mistaken. Supply and demand, too, have been with us for a long time, yet no one[4] is calling for their amendment. People still engage in human action (Mises 1998), attempting, thereby, to replace a world less to their preference with one more to their liking. This cannot be all there is to the challenge.

Nor is it. Wagner now brings forth his "exhibit A" in the case against the Austrian theory of the cycle: "the primary criticism that has been advanced against Austrian cycle theory, which is that the Austrian theory assumes that entrepreneurs are foolish in that they do not act rationally in forming expectations." He continues:

> The primary line of informed criticism of traditional Austrian cycle theory is that it ignores some elementary requirements of rationality in economic life and modeling. . . . This is seen most easily by starting from the Hayekian initial position of general equilibrium, and then comparing a general reduction in time preferences with a sudden expansion in central bank holdings of government debt. The fall in time preference leads to an increased demand for capital goods and a lengthening of the structure of production, as the increase in saving finances an expansion in capital investment. The increased holding of government debt by the central bank is likewise held to finance an expansion in capital investment, only in this case the saving that finances the investment is forced and not voluntary.
>
> The comparative statics of these two cases seems clearly to presume that people possess but weak capacities to form expectations. The fall in time preference leads to a permanent shift in the structure of production, whereas the monetary expansion brings about an oscillation in the structure of production, with an initial increase in roundaboutness subsequently followed by a decrease. The central bank's expansion of credit is treated as indistinguishable from a general increase in the desire to save. Both instances arrive as surprises, and the two types of surprise are indistinguishable from one another. This situation might have had plausibility when

[3]Praxeological theories are timeless, and applicable to the real world at any epoch. For an elaboration, see Batemarco (1985), Block (1973, 1980), Bostaph (1978), Cubeddu (1993), Egger (1979), Fox (1992), Garrison (1993), Gordon (1993), Gunning (1988), Hoppe (1988, 1989, 1993, 1995), Huerta de Soto (1998), Mises (1978, 1979, 1985, 1990, 1998), Rizzo (1979), Rothbard (1951, 1957, 1976a, 1976b, 1991, 1997b, 1997c), Selgin (1988), Smith (1996), White (1984).

[4]With the possible exception of Card and Krueger (1994).

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> Austrian cycle theory was initially formulated. The collection of economic statistics was primitive. Central banks were committed to exchanging their notes for specie. There was no developed community of financial observers and Fed watchers.
>
> Throughout the postwar period, however, we have become ever increasingly removed from that earlier time. Statistics, observers, and pundits are everywhere. A cycle theory that depends on the inability of people to distinguish, in the aggregate, between an increase in personal saving and an increase in central bank holdings of government debt must rightfully be dismissed on the grounds that it fails to incorporate any reasonable requirement of individual rationality in economic action. The aggregate data are widely and readily available. Austrian cycle theory is animated by a clustering of entrepreneurial error, and in the canonical statements that error would seem to reside in the inability of entrepreneurs to distinguish an increase in saving from an increase in central bank holdings of government debt.

This seems at first glance like a telling criticism of the Austrian business cycle, but it is not.

First of all, Austrian theory, by Wagner's own admission,[5] is hardly well-known.[6] All the Federal Reserve shadow open market committees and savings bank watchers in the world won't help anticipate and obviate the Austrian business cycle if no one knows what to watch for. The point is, Wagner is charging that if all investors knew full well the Austrian business cycle theory, and furthermore were acquainted with the fact that a particular fall in the market rate of interest below the originary rate was due to the central bank and not to a change in time preference, then no one would engage in resource misallocation in the direction of lengthening the structure of production. In fact, however, as Wagner himself attests, virtually no one knows of ABC, and most of those who have ever heard of it reject it, mostly very contemptuously. But this is a minor point, the force of which will atrophy when and if ABC gains the popularity it deserves on its intellectual merits.

Second, and far more serious, Wagner's analysis is marred by the implicit hypothesis that the only thing needed to obviate the ABC is an assumption of reasonable expectations. Certainly not perfect assumptions, as in some variants of the rational expectations model, but just the sort that are likely to be formed by all of these fed watchers and financial pundits he lovingly mentions.

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[5]States Wagner (2000), "[T]he Austrian insights have experienced no renaissance within the universe of macro theorizing." And: "Traditional Austrian cycle theory is not now a serious competitor as an explanation or characterization of economic fluctuations."

[6]Rosen (1997) exults in this. For rejoinders, see Block (2000), and, paradoxically, Yeager (1997). See also Laband and Tollison (2000), Vedder and Gallaway (2000), and Anderson (2000).

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There are several difficulties here. For one thing, if the data are so "widely and readily available" and the commentators so sophisticated, from whence spring bull and bear markets? Why, for example, didn't any of these people predict the precise "contours" of the vicious attack on Microsoft launched by the Justice Department (Anderson, et al. forthcoming), the specific implications for the stock market in general, and in particular, for computer stock prices?

For another, why didn't they share it with everyone? Even on the assumption of accurate expectations, due to all these institutional changes in the direction of greater sophistication, all market participants will scarcely believe them. The point is, even on these assumptions, the Austrian "cluster of error" will still be available to act as an impetus for the ABC.

Expectations are a big part of the ABC story, but they by no means exhaust it. There is also the fact that by artificially lowering the market or loan rate of interest below that of the originary or real rate, not only are expectations pushed out of whack, but entrepreneurs are in effect *bribed* into making otherwise unwarranted investments in the higher orders of the structure of production. This is a very crucial point, completely ignored by Wagner. Even if we can somehow assume entirely accurate expectations, but not on the part of every market participant, this would not at *all* stop the ABC dead in its tracks.[7] Not only does a divergence between the loan and real rates of interest set up expectations about the future course of economic events, it also confers *benefits* upon those who act in accordance with them–that is, those who shift resources from the lower to the higher orders of production in response to a lowering of the loan rate of interest, *even if they know this emanates from Fed machinations, not a change in time preference, and thus can only be temporary.* The trick, of course, is to get the timing right: to get in while the getting is good, and to leave someone else holding the bag right before the onset of the downturn in the ABC. But as long as expectations are not perfect and uniform, there is no reason such a scenario cannot obtain.

Let us consider an analogy, far removed from the ABC. Suppose that the proportion of peas to carrots that will satisfy consumer demand is 1:1. The government, however, decrees that the appropriate proportion is 2:1, and begins to subsidize pea production. Third premise of the syllogism: Sophisticated (but not all) investors know that this policy cannot last, that there will be political or other repercussions, and eventually the government

[7]According to the old aphorism, "there is a sucker born every minute." On the assumption that the Austrian cogniscenti are familiar with ABC, but that this does not apply to all market participants, the latter will tend toward bankruptcy. But if new investors not sophisticated in Austrian economics are born every day, then, still, the ABC can be generated by inflationary policies of government, even in the absence of the bribery effect.

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will have to pull in its horns and cease its mischievous attempt to reallocate resources.[8] The question is, will this suffice to set up a peas-and-carrots cycle, given an tendency of government to pursue such policies whenever politically feasible? Wagner, implicitly, would argue in the negative, on grounds that, in the long run, this policy cannot persist. He would maintain that knowledgeable investors will not sink their money into peas because the subsidy will eventually be yanked out from under them, and excessive pea production will be shown at a later date to have been missallocative.

It is perhaps easier to see the error of Wagner's ways with the help of this analogy. Obviously, even far-seeing economic actors would indeed willingly invest in excessive pea production[9] under these conditions, secure in the knowledge that they could better predict the turning point. That is, right before the government stopped its pea subsidy program, while pea resources were still at a high, the far-seeing economic actors would unload peas upon less sophisticated investors. Wagner stresses the "heavy emphasis placed on entrepreneurship in Austrian economics," as well he might (Mises 1998; Kirzner 1973). But part and parcel of entrepreneurship is the ability to outguess competitors.[10] If all market participants always know exactly the same thing, then there is no scope at all for the entrepreneurship that Wagner says he so admires in the Austrian tradition.

Our author continues his critique: "How is it possible to claim validity for Austrian cycle theory in the face of rationality in expectations? Such validity cannot be based on any claim that *people* cannot distinguish changes in saving from changes in central bank holdings of government debt" (emphasis added).

What "people?" Of course, *some* people can perhaps make this distinction, while others cannot. Wagner himself maintains, "What is surely most notable about people and their expectations, however, is their heterogeneity and not their homogeneity. This heterogeneity starts with biology, and from there spreads throughout the social and economic universe. One aspect of this

---

[8]This would be equivalent to the fact that inflation can easily get out of control by setting up inflationary expectations which exacerbate the situation, that is, raise the rate at which a given financial injection causes a certain amount of inflation. And thus, eventually, the inflationary party will have to stop, if it is not to eventuate in hyperinflation and the unraveling of the economy. See on this Hayek (1972), Mises (1971).

[9]We are of course assuming only profit-maximizing behavior: we eschew the motive of purposely reducing wealth mentioned in (Rand 1957).

[10]States Wagner: "A presumption of rationality in expectation is surely a requisite for any kind of Austrian theorizing." No truer words were ever uttered. But surely this does not imply the sort of "rational expectations" where all of knowledge–past, present, and future–is available to everyone. For that would not be Austrianism, but, rather, perfect competition, its antithesis. See on this Hoppe (1997) and Wood (1978a, 1978b).

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heterogeneity would be differences among people in their objects of expectation." But if people can differ in the expectations engendered in them by economic variables and their alterations, then Wagner's contention that the ABC cannot arise on the basis of differing interpretations of inflation and its effects on interest rates becomes difficult to defend.

Not to put too fine a point on this, but Wagner contradicts himself. On the one hand he maintains that the ABC cannot be generated in the way Mises and Hayek say it can, because, in effect, *everyone* can "distinguish changes in saving from changes in central bank holdings of government debt." On the other hand, he highlights heterogeneity, even rooting this in something as basic as biology, forsooth. He simply cannot be allowed to have this both ways. He is correct in his latter contention, not his former one. That is, people are indeed heterogeneous in their expectations.[11] And no, he has not laid a glove on ABC theory.

A word about the ease of "distinguish[ing] changes in saving from changes in central bank holdings of government debt" in terms of deviations in interest between originary and loan rates: Wagner speaks as if this is as easy as falling off a log. Not so, not so. The originary or real rate of interest is a theoretical construct. Based on time preference, this does indeed drive the market or loan rate, but is itself invisible for all that. Yes, if savings increase, as reported to us by Wagner's much vaunted modern institutional arrangements, this is a prima facie indication that time preference rates have decreased–but only if *ceteris paribus* conditions hold, and Wagner certainly has no warrant for any such assumption.

Another difficulty with the Wagnerian presentation is that it focuses on the loan market and its market rate of interest. But as Rothbard (1962, pp. 360-64) points out, under the heading of "The Myth of the Importance of the Producers' Loan Market,"[12] the key element in interest rate determination is not the rate of interest prevailing on loans, but rather the price spread between the various levels in the structure of production. The latter is the dog, the former only the tail. In other words, it is the market rate of interest which must conform to these price spreads, based on time preference, not the other way around.[13, 14]

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[11]And just about everything else as well.

[12]Perhaps the least tenable cut at Austrianism in Wagner (2000) is his dismissal of Rothbard (2000) as a mere "restatement" of ABC, and his refusal to even acknowledge Rothbard (1962).

[13]Just because in the evenly rotating economy all of the various rates of interest, and the time discount of one stage of production vis-à-vis another, must all come into conformity does not mean that we cannot single out some of these phenomena as basic, and others as less so. Nor would it be legitimate for Wagner to rely upon their undoubted equality in equilibrium as a justification for substituting one for the other in the real world, since we never attain such a state of affairs.

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WHEAT

So much for the "chaff" that Wagner sees in ABC theory. Incomprehensibly, when we get to the "wheat," instead of his thesis becoming clearer, it gets muddled. In his own words:

> A claim that in the aggregate lenders cannot increase their volume of profitable loans does not mean that no loans will be made by rational, profit-seeking lenders. An ex post postulation of zero profits in the aggregate translates into an ex ante expectation of zero profits for all lenders only through the invocation of general equilibrium as a modeling constraint. Otherwise, there is plenty of reason to think that some credit expansion will result. For one thing, few people think of themselves as average or representative competitors in any field of endeavor. It may be generally believed that only a relatively few new opportunities for profitable loans will materialize. There is, however, no selection procedure that chooses those opportunities and matches them to lenders. In a process of open competition where most competitors think they are above average, it is surely plausible that an aggregation of ex ante commercial calculations will lead to an expansion in the volume of loans.

What is this but the rudiments of ABC theory? Granted, it is not as precise as the versions rendered by Mises (1998), Hayek (1935), Rothbard (1962, 2000), Garrison (1989, 1991, 2000), and O'Driscoll (1977). It lacks recourse to the structure of production, to the deviation between market and real rates of interest, to the cluster of error, and other elements of the so-called chaff. But in one short paragraph, Wagner has at least articulated a recognizable version of the ABC theory. It is an inferior version, elevating "false trading" to a core position without investing this phenomenon in its usual clothing, but for all that, it is at least recognizably, if opaquely, Austrian.[15]

Also in the Austrian tradition are Wagner's remarks:

> An economy can be represented by a network of human activity, some of which is engaged in executing original plans and some of which is engaged in rectifying plans that have judged to have been unsatisfactory. This distinction between types of activity is, of course, an analytical and not an empirical distinction. There is no way that a census could be taken to determine how much activity is devoted to executing plans and how much is devoted to revising plans that have been judged unsuccessful.

Here, he seems to be admitting that ABC theory is praxeological, not empirical. If so, why is there need for revision on the basis of new institutions?

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[14]Wagner also incorporates into his analysis "aggregate variables," but these play no role in Austrian praxeological considerations.

[15]Similarly, is his call to place macroeconomics "on adequate microfoundations." This is strict classical ABC theory.

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No one denies that alternative ways of doing things may or may not make praxeological theories irrelevant, in the sense of not being applicable. But Wagner, in urging his "chaff" thesis, is clearly going beyond these parameters.

It is time to bring this discussion to a close. Wagner set out to separate the Austrian wheat from the Austrian chaff, in an attempt to retain the former and jettison the latter. It is difficult to see in what way he has succeeded.

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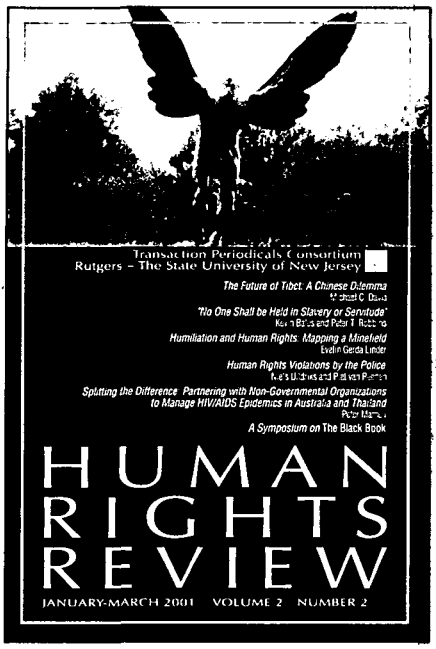
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Subjectivism and Economic Analysis: Essays in Memory of Ludwig M. Lachmann. Edited by Roger Koppl and Gary Mongiovi. London: Routledge, 1998

Though little known among the economics establishment during his lifetime, Ludwig M. Lachmann was always widely connected. The range of scholars whom he knew and with whom he communicated was truly impressive. Since his death in 1990, he has become better known, particularly among heterodox economic scholars representing a wide variety of viewpoints. His appeal to such a heterogeneous group is undoubtedly to be found in his insights regarding the nature and importance of knowledge. This is reflected in this interesting book of essays honoring his memory. The book is edited by two scholars who, while differing in their approaches to economic doctrine and policy, share an appreciation of Lachmann's scholarship, and an appreciation of his intellectual honesty, his methodological subjectivism, and his interest in endogenous change.

The depth of such admiration comes through in the introductory chapter, in which Koppl and Mongiovi provide a brief outline of Lachmann's life and work and an overview of the chapters to follow. The introduction is helpful in placing Lachmann as perhaps the most Keynesian of the Austrians, a thinker subject to many diverse influences (such as Max Weber and his early teachers Werner Sombart and Emil Kauder), in turn influencing scholars of many different backgrounds. The account of Lachmann's early academic life adds a little to earlier accounts in suggesting that he had already absorbed much of Austrian theory before going to Switzerland, where he first studied it systematically. I balked at the description of Lachmann as a "liberal" in this early German period (or at any time). I suppose our authors meant to say that Lachmann had already developed an abiding appreciation of the qualities of the market process and thus in the importance of free markets, but it seems to me that Lachmann did not share the degree of commitment in principle to free markets that Mises had, or the very strong pragmatic faith that Hayek, for the most part, seemed to have. It is true that his basically pro-market views probably placed him in danger in the Germany of 1933, but I am not sure we should describe him as a "liberal."

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The contributions in the book are diverse in nature. They all try, with varying success, to link their message to Lachmann. In the case of Brian Loasby's "Ludwig M. Lachmann: Subjectivism in Economics and the Economy," this is not difficult. There is a natural affinity between the two thinkers. Loasby, as always, is thoughtful, insightful, and provocative. The chapter was for me perhaps the most interesting of the book because it draws on a personal correspondence between Loasby and Lachmann that is most revealing of Lachmann's views on such matters as firms, institutions,[1] and the place of Marshall in economics and in relation to the Austrians. Loasby also provides an interesting analysis of Lachmann's last book (Lachmann 1986). He persuasively argues that Lachmann is "perhaps the most Mengerian of Austrian economists" (p. 20), that his ideas complement some of Karl Popper's (p. 14), and, more provocatively, that Lachmann can be thought of as the "founder of the modern-capability-based theory" of the firm (p. 25). This chapter is full of interesting ideas for those inclined to speculate about Lachmanian themes.

The relationship between Lachmann's and Mises's methodology is examined by Steven Parsons's "Mises and Lachmann on *Human Action*." This chapter will be of interest to those familiar with the linking of Lachmann's work to the hermeneutical turn. Parsons criticizes both Lachmann and Mises from this point of view.

In "Lachmann and Subjectivism of Active Minds" Roger Koppl provides an interesting link from Lachmann's expectations to the work of Alfred Schutz and to Hayek's evolutionary theory. This draws upon some of Koppl's other work (in collaboration with Butos and Yeager) on "big players" and "herding" in asset markets. It is clear that Koppl has a subtle understanding of Lachmann's theory of mind and what it implies in real-world settings.

Laslo Csontos died before the publication of this book and so his contribution "Subjectivism and Ideal Types," was published posthumously. Csontos seems to have been an interesting thinker. Nevertheless, it appeared to me that this essay made some unwarranted assertions. In particular, Csontos attributes a methodological solipsism not only to Lachmann (a claim made, erroneously I believe, by others) but also to Mises and Hayek. This dubious claim casts doubt on the relevance of the rest of the essay. Still, the arguments are complex, and others may wish to examine it to see if perhaps there is more there than I was able to see.

The relevance of the next chapter "Endogenous Change, Open Systems and Provisional Equilibrium" by Maurizio Caserta is similarly in doubt, but

[1]For example, just before his death Lachmann expressed the following in relation to the transition problem facing Russia, "The more I think about Russia the more pessimistic I become. How can this end well? Of course market institutions cannot be introduced by political fiat" (letter of July 1990, pp. 13-14).

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for different reasons. Caserta constructs a formalistic model which "assumes a closed capitalist economy that produces one good using two factors only: homogeneous labor and capital. Technology is given and . . . firms are identical" (p. 116). One could hardly imagine anything less Lachmanian in spirit, in spite of Caserta's attempt to find links to Lachmann's concerns.

In "Radical Subjectivism and Austrian Economics," Carlo Zappia takes Austrians to task for criticizing straw men. According to Zappia, the neoclassical economics of static, perfectly competitive equilibrium is no more. Instead, current economics has moved beyond this–in the work of Hahn, Radner, Grossman, Milgrom and Roberts, and Stiglitz–and Austrians would do well to take note of and incorporate some of this work (in the economics of information, game theory, and other areas). Zappia is not alone in this sort of plea (see, for example, Foss 2000). My own view is that modern Austrians are caught in a difficult dilemma here. Much of the work to which Zappia refers is a variation on the perfectly competitive theme and does not really come to terms with the subjectivist insights of the Austrians, and, while it would be easy to point this out (see Thomsen 1992), modern Austrian scholarship is already very long on criticism ("negative heuristic") and short on positive contributions. The solution would be for Austrians to "just do it," to offer more positive contributions, perhaps taking note of and incorporating some of the work to which Zappia refers where appropriate.

Steven Horwitz provides a nice discussion of Lachmann's ideas on institutions in chapter eight ("Hierarchical Metaphors in Austrian Institutionalism: A Friendly Subjectivist Caveat"). He suggests that, while social institutions, like language and law, provide indispensable coordinating functions for the actions of individuals driven by subjective and disparate expectations, these institutions themselves rest on subjective perceptions and anticipations which, over time, could be falsified, and they will evolve and mutate. To see them as "objective" fixed points in the subjective shifting landscape is erroneous. There is no fixed hierarchy in which objective higher-level institutions serve as a backdrop against which to interpret the subjective meanings of economic actors. While I readily agree with Horwitz's (Lachmanian) understanding of institutions, I am less comfortable with his suggestion that Lachmann objectified them. I doubt that Lachmann would plead guilty (on this, see Lachmann 1994). Rather, I think the contextuality of the institutional structure is the real point. An example is the evolution of company law.

> Company Law, as it has emerged in the Western world in the course of time, is a delicate web within which many interests, some conflicting, some complementary, have been woven into a pattern of harmony.
>
> On the other hand, there is no company law of which it could be said that it preceded legislation. As soon as the resources for organizing joint ven-

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> tures with limited liability and the opportunity for their use were present, there also arose the need to give them an adequate legal form, e.g. in the form of a royal charter, or in some other way. Participants in the venture needed this minimum of "calculability." Modern joint-stock enterprise is of course the creation of the market (in Menger's terminology an "organic institution") but it could not have come into existence without a legal form expected to be permanent.
>
> Company Law, in short, the joint creation of market growth and the legislative embodiment of ideas pertaining to the market, is the final product of a long process of interaction of business men and lawyers who invested their experience, their ingenuity and their skills in it. (Lachmann 1994, pp. 254-55)

So I think Lachmann has, in many ways, anticipated Horwitz's main point, but this in no way diminishes its validity or his interesting discussion and extension. The evolution of institutions, such as company law, proceeds within the context of the evolution of the market itself–leading one to alternately shift one's perspective as to which is the landscape and which is the foreground (much like shifting images in a holographic picture).

Students of Lachmann's work will find a fascinating discussion of a puzzle in his approach to business cycles in Peter Boettke and Steven Sullivan's "Lachmann's Policy Activism: An Austrian Critique of Keynesian Proclivities". I found that this chapter addressed some of my own questions, particularly my inability to understand Lachmann's discussion of macroeconomic policy in chapter seven of his *Capital and its Structure* (1978, p. 126). His call for an active and targeted credit expansion policy in the secondary phase of a recession seemed to me to be at odds with his epistemology, with his single-minded portrayal of knowledge as subjective and idiosyncratic. How, I wondered, in Lachmann's framework, were the policymakers to know what to do? Boettke and Sullivan supplement their discussion of this puzzle with a consideration of one of Lachmann's earlier and unpublished works: his master's thesis, written in 1935, which echoes this theme in a more definite way. When I first looked at the thesis, my inclination was to assume that the young Lachmann had not yet formed his mature opinions, and that in the passage of time he had modified his position. (This was certainly true about his capital theory.) But Boettke and Sullivan's juxtaposition of the 1956 and 1935 works made me realize that this was an enduring aspect of his thought. One might also note that a second edition of *Capital and its Structure* was published in 1978, and Lachmann specifically says in the new preface that he passed up the opportunity to make any changes. So the puzzle remains.

Boettke and Sullivan consider three possible explanations: Lachmann (1) "contradicted himself; (2) presented us with a fully coherent set of policy arguments; [or] (3) established the validity in theory of the policy positions he takes

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but left no basis for their rational implementation" (p. 165). They quickly reject the second explanation, perhaps too hastily, in that they wonder how the policymaker's position can be "epistemically privileged" within Lachmann's scheme. And they argue that the first explanation is also wrong; that Lachmann did not contradict himself, since the assertion of the necessity to reshuffle malformed capital combinations can be squared with his understanding of capital. This leaves the third explanation as the valid one. It seems to me, however, that the three explanations may not be mutually exclusive. It is possible that Lachmann may have thought that policymakers indeed could have the necessary (not necessarily privileged) information, *but only in some circumstances*–the circumstances of a secondary slump–but Boettke and Sullivan are correct in suggesting that an insufficient basis has been developed for this view, and that it certainly seems to strain, if not contradict, Lachmann's overall approach (for example, his capital-based criticism of growth theory and Keynesian investment theory). It remains for me a puzzle, but one that is significantly illuminated by Boettke and Sullivan's discussion.

The final chapter also has a Keynesian theme. In "Expectations and Stock Market Prices," Jochen Runde and Jörg Bibow deal with the question of convergent and divergent expectations in asset markets. This is a subject that interested Lachmann greatly. He thought of the daily determination of stock prices as a sort of temporary equilibrium, in the sense that the bulls just balanced the bears. Runde and Bibow investigate the behavior of divergent expectations about the future price of a stock and how this may serve to narrow the divergence of expectations about its "correct value," a paradoxical and interesting idea.

This book can be read most profitably by those already familiar with Lachmann's work, but others may be stimulated by it to know more about Lachmann. Overall, this is an interesting collection of essays and one which certainly fulfills its mission to honor the memory of Ludwig Lachmann.

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Wages and Labor Markets in the United States, 1820-1860. By Robert A. Margo. Chicago: University of Chicago Press, 2000

For the past century or so, a persistent theme among some leftish economists and economic historians has been that wages showed virtually no growth from 1820-1860, during the formative stages of American industrialization. Even though output rose by 60 percent or so per capita, the "pessimist" historians have told us workers merely held their own. Under those assumptions, the worker share of the national income must have fallen dramatically, from, say, 60 percent to perhaps 38 percent. Yet there is little or no evidence that such a dramatic shift in income distribution or factor shares occurred.

Enter Robert Margo. In his new statistics-laden tome for the National Bureau of Economic Research, *Wages and Labor in the United States, 1820-1860*, Margo concludes what Austrian economists have surmised all along, namely that the rise in real wages during this period very closely approximated the rise in worker productivity (both grew about 1 percent a year). Moreover, on balance, Margo thinks markets worked pretty well in several other respects, most importantly in reallocating labor from agricultural to nonagricultural pursuits. There was essentially no differential in real wages between farm workers and those doing comparable non-farm labor by 1860, for example.

The major bottom-line conclusions arising from Margo's exercise are congenial with Austrian–and, for that matter, neoclassical–economic theory, and they generally are carried out thoroughly and with apparent objectivity and care. Nonetheless, the work reinforces Austrian suspicions about excessive reliance on statistics derived from aggregating data from multiple economic agents. A few examples will suffice.

First, the major source of wage data Margo uses is monthly payroll records of civilian workers at U.S. Army posts. Putting aside the very real issue of whether the federal government truly paid local market wages then (they are not particularly prone to do so now), the sixty-two thousand observations in

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the sample over a forty-year period are heavily skewed toward frontier areas that may not be representative of national or even regional trends. (Margo uses four broad regions in discussing wage changes.) For example, we learn (p. 51) that from 1820 to 1860, real wages of artisans in the Northeast rose fairly sharply (1.18 percent a year), while they actually fell slightly in the Midwest. (This naturally raises the question: Why was there mass migration from the Northeast to the Midwest?) Yet it turns out that nearly two-thirds of the Midwestern artisans, and about one-fourth of those in the nationwide sample, worked in the single state of Kansas, at a time when Kansas, even in 1860, had only about 0.35 percent of the national population. There was no representation from vastly more populous states, such as Illinois and Indiana. Similarly, a majority of the observations from the South Atlantic states came from Florida, a smallish and generally unrepresentative Southern state before 1860. More than 40 percent of the entire U.S. sample, then, came from Kansas and Florida, states that collectively comprised well under 1 percent of the U.S. population even at the end of this time span.

This is not the only reason to be somewhat suspicious of some observed regional variations in wage patterns, however. Margo would have us believe (p. 72) that in the single year 1829, real wages for artisans fell 13 percent in the Midwest, while they rose an extraordinary 12 percent in the South Atlantic states. Yet the reason for this, Margo's data (p. 70) show, was that prices were rising over 14 percent in the Midwest, while they were actually falling in the South Atlantic states. Conventional wisdom, even among mainstream economists, is that today's consumer price index significantly misstates inflation. The price aggregation problem of today is multiplied several fold if one tries to use regional instead of national data, not to mention the use of limited data that are computed more than one hundred years after the fact. Moreover, Margo's nineteenth-century price indices are, out of necessity, almost entirely based on the value of food prices, excluding significant items that people then and now spend money on, such as housing. They also assume away any intraregional price variation.

In Margo's defense, he is trying to derive historical facts from limited, imperfect data, and he labors with great skill and diligence in carrying out the tedious task. And, for all of their limitations, over the longer run, the conclusions Margo reaches sound reasonable and consistent with what was market-driven behavior in a largely laissez-faire society. Yet, given the real hazards associated with constructing wage and price indices for the period, Margo sometimes does not adequately qualify conclusions that inevitably must be somewhat speculative. By concluding that, by and large, "markets worked," however, Margo perhaps moves more economists toward accepting conclusions consistent with Austrian economic theory, if not epistemology.

Reading Margo left me with a horrifying thought. Some late twenty-first-century or even twenty-second-century cliometrician might evaluate the modern

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era much like the twentieth-century pessimists commenting on the early-nineteenth century. Going to the 2000 edition of the *Economic Report of the President*, page 360, reveals that real weekly earnings were lower in 1999 than in 1962. Yet the data on page 341 show that real GDP per capita more than doubled in the same time span. From this, it is concluded that workers were relentlessly exploited and had stagnating living standards, while capitalists flourished, ignoring other tables which show that corporate profits did not rise as a proportion of personal income (p. 338), or that real per-capita consumption spending more than doubled (p. 341).

The data showing no rise in real wages are, quite simply, wrong, and for numerous reasons, including the problems of aggregating prices (the overstatement of inflation with the CPI), the failure to include fringe benefits, and the lack of adjustment for the better and safer working conditions in today's work environment. The problems with today's data are not new, as Bob Margo's well-done scholarly exercise demonstrates. In trying to unravel the truth about our past, Margo supports some basic truths about the efficacy of markets. He does not fully convince us, however, on some of the details of economic progress during America's drive to industrial preeminence.

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The Austrian Subjectivist Theory of Interest: An Investigation into the History of Thought. By Ingo Pellengahr. London: Peter Lang, 1996

Many of the disputes in economic theory are the result, not of genuine disagreement on fundamental issues, but of the contradictory uses of terminology. This deplorable phenomenon is perhaps nowhere better exemplified than in the complex controversies that have historically raged in capital and interest theory.

Ingo Pellengahr's doctoral dissertation, *The Austrian Subjectivist Theory of Interest*, focuses on one small aspect of these ongoing debates. He traces the development and evolution of what is generally referred to as the (pure) time preference theory (PTPT) of interest. The PTPT is historically associated with the Austrian School, whose characteristically subjectivist members stress the primacy of individual valuations–versus objective facts concerning the productivity of capital–in any discussion of interest. Pellengahr offers a largely critical review of the major Austrian contributions to the evolving PTPT and then presents an original, "essentialist" synthesis which he hopes will be acceptable to the various factions in the debate.

It must be stated at the outset that Pellengahr's book assumes a thoroughgoing familiarity with all of the relevant literature; the reader who finds Mises's treatment of Böhm-Bawerk in *Human Action* to be obscure will gain little from Pellengahr's discussion. This review will likewise assume such a familiarity and thus cater only to the book's relevant audience.

Pellengahr's greatest contribution is his attempt at terminological and conceptual clarification. As noted above, the Austrian treatment of capital and interest theories has been plagued by systematic confusion in this regard. It is precisely for this reason that Pellengahr devotes his entire chapter three to an "Excursus: On the Definition of Time Preference."

There are two related, but distinct, meanings attached to the term *time preference*. One meaning, generally employed by the Austrians, refers to the higher subjective value placed on a marginal unit of a good available *now* rather than the "same" unit not available until *later*. A neoclassical would refer to this concept, not as positive time preference, but rather as the marginal rate of substitution of present for future goods being lower than one.

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The second meaning, employed by all current neoclassicals, refers to the "exogenous" (ex ante) preference for present goods. Thus, a person exhibits time preference, not if he actually prefers present to future goods, but rather if, *hypothetically speaking*, he would prefer a present-oriented consumption stream to the "same" stream distributed uniformly throughout time. If certain assumptions about the agent's ordinal preferences are made, the neoclassical can reduce his concept of time preference to a numerical discount on future utility. Thus, if a good consumed next year will *at that time* yield 50 "utils," then the agent, anticipating this future consumption, will evaluate its marginal utility as only, say, 25 utils, because future utility is discounted.

Under this latter interpretation, it should be noted, time preference is neither necessary nor sufficient for a higher valuation of present over future goods. For example, it might very well be the case that an individual discounts future enjoyments (that is, possesses time preference in the second sense), but due to a relative abundance of wealth in the present, the individual would nonetheless prefer consumption of a marginal future to a marginal present unit of a good.

It must also be kept in mind that this distinction between the two meanings of the term is not important merely for dialogue with outsiders. Even if the Austrians care not a whit for neoclassical treatments of interest, such a distinction must be recognized to maintain the coherence of their own discussions. Throughout his book, Pellengahr tirelessly documents countless examples—even in the works of such giants as Mises and Rothbard—where the absence of such recognition leads to unsatisfactory argumentation.

Having praised Pellengahr's unrivaled care in untangling the various contradictory uses of the term *time preference*, it must sadly be concluded that Pellengahr misunderstood Böhm-Bawerk's seminal contribution. An interpretation of Böhm-Bawerk's theory follows here in order to clarify the shortcomings of Pellengahr's analysis.

Piercing the web of confused discussion concerning capital and interest, Böhm-Bawerk made the simple yet elegant claim that interest is nothing but an intertemporal exchange. As such, if a premium is placed on present versus future goods, this can only be due to a higher subjective valuation of present goods. As Böhm-Bawerk himself thought, this insight is "the nub and kernel of the theory of interest" that he presented (*Capital and Interest*, vol. 2, *Positive Theory of Capital*, George D. Huncke and Hans F. Sennholz, trans., South Holland, Ill.: Libertarian Press, 1959, p. 259).

Had Böhm-Bawerk simply stated *this*, his contribution would have been noteworthy, for the marginal and subjectivist revolution had not yet worked its way through the prevailing interest theories of Böhm-Bawerk's day. But, as Fetter pointed out, this "nub and kernel" really is no *explanation*; it is rather a reformulation of the problem. If one wants to know why a capitalist receives

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interest, it will not do to simply state that this is "due" to the fact that people value present dollars more highly than future ones. It is this more fundamental "undervaluation" of future goods which must be explained.

Böhm-Bawerk attempts to provide just such an explanation. Present goods as a rule are more valuable than future goods for three main reasons. First, people generally expect to be more richly endowed in the future, and thus present consumption (on the margin) appears more urgent. The second reason is that future wants tend to be systematically undervalued; what will yield a utility of 50 next year is only *now* perceived as yielding a utility, say, of 25. (Thus, if all else is equal, one unit now will exchange for two units next year.) The final reason is that, as an empirical technological fact, more "roundabout" production processes are more *physically* productive than less roundabout ones. It is the combination of all three reasons (the second of which is broken down into subsidiary causes) that yields the general rule that present goods are more valuable than future goods, which implies a positive interest rate.

The first reason is innocuous enough. The second—the discount of future utility—is, of course, what neoclassicals mean by "time preference." It is an exogenous fact, not influenced by considerations of relative supply, which is handled under the first cause. The third cause—the one responsible for inordinate controversy—simply refers to the fact that one can often obtain more of a given end by first achieving an intermediate, and not directly useful, end. Thus, if one wants to eat apples, one method is to climb trees and directly pick them. But another, more "roundabout" approach, is to first construct a long pole (which in itself is useless) and then use it to knock down many more apples than could be had by the more direct method. Perhaps a different way of expressing Böhm-Bawerk's third cause would be to say that, as a general technological fact, capital goods can be constructed whose physical productivities exceed the sum of the physical productivities of their inputs.

In a discussion of a different book, it certainly would be inappropriate to dwell further on the reviewer's idiosyncratic views. Having said that, I want to stress that the above understanding completely exonerates Böhm-Bawerk from the frequent charge that he unwittingly reverted to the productivity fallacies that he had so brilliantly demolished in volume one of his great work, *Capital and Interest*. Irving Fisher's charge—that the third cause is superfluous and entirely subordinate to the first two—is more tenable, and indeed Böhm-Bawerk himself did not adequately address this concern. This was due to the unfortunate tendency for *all* interest theorists—even the Austrians—to focus on "steady-state" situations. If we allow for unexpected, one-shot changes, it would seem possible to assign the third cause a genuinely independent role.

In light of the above discussion, an objection must be made to Pellengahr's apparent endorsement of the unanimous PTPT rejection of Böhm-Bawerk's

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third cause (p. 21). Further, I must strongly object to Pellengahr's claim of Böhm-Bawerk's inconsistency on the use of the term "time preference" (p. 23) –a claim made all the more dubious by Pellengahr's own admission that Böhm-Bawerk does not even employ the term. Thus, Böhm-Bawerk's apparent inconsistency is in reality a reflection of the (rare) failure of Pellengahr himself to keep distinct the two notions of "time preference." These quibbles aside, chapter three alone makes Pellengahr's book indispensable to the Austrian theorist. Our author documents the surprising lack among the Austrians (with the exception of Rothbard) of a formal definition of time preference, and the myriad difficulties inherent in the various definitions which are implicit in their discussions.

Pellengahr devotes a chapter each to Fetter, Mises, and Rothbard. Except for those arguments tainted by his confusion regarding Böhm-Bawerk's theory, Pellengahr's analysis in these chapters is simply impeccable. In particular, the brief yet incisive analysis of Mises's attempts to prove the *a priori* necessity of time preference was enjoyable. The proponent of Mises's treatment in *Human Action* must deal with Pellengahr's informed critique.

(Commenting on Mises's second "case of capitalist saving," Pellengahr says, in characteristic understatement, "Assuming a positive rate of interest in a setting designed to shed light on the reasons for a positive rate of interest is, moreover, clearly of particularly dubious value" [p. 42]. This critique, though powerful, is exceptionally polite.)

This standard of excellence is maintained throughout Pellengahr's treatment of the more recent Austrian contributions. However, I disagree with his handling of Roger Garrison, who is treated unfairly, and of Charles Baird, who is let off the hook too easily. Pellengahr characterizes Garrison's interpretation as "vague and ambiguous" (p. 53), whereas I found Garrison's (as well as Walter Block's) writings on the PTPT to be very clear.

Pellengahr rightly criticizes Baird's discussion of time preference, particularly in his section, "The Primacy of Time Preference" (p. 56). However, as noted above, Pellengahr is far too lenient. In this section, Baird "proves" the primacy of time preference by imagining a man who owns two sheep, which will multiply into three sheep in one year. Baird supposes the man has no time preference and argues that if the "future market value" of the three sheep next year is higher than the market value of the two sheep this year, then the man, since he has no time preference, will postpone consumption of his capital stock to "reap the gain." By such action, the market value of the future sheep will decline (due to increased savings) until the market value of two sheep *now* equals the "future market value" of three sheep next year. Thus, the man's capital goods will not appreciate in value over time, despite their postulated net physical productivity. Baird concludes that time preference is "necessary and sufficient" for a positive rate of interest.

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The problem is that Baird assumes what he is trying to demonstrate. If "zero time preference" is *the same thing* as equal valuation of a present dollar of revenue and a future dollar, then *obviously* time preference is "necessary and sufficient" for positive interest rates. But if this is really Baird's argument (and it is), he could simplify it greatly. He needn't refer to sheep. All he need do is suppose a man places $100 in a savings account. If the man has "zero time preference," then he doesn't care *at what date* he withdraws his money; therefore, if the "future market value" of his account–i.e., his balance–exceeds $100, he'll postpone his withdrawal. In such a setting, equilibrium can only be achieved if the interest rate is zero percent. Thus, time preference is necessary for a positive rate of interest.

Needless to say, *this* sort of argumentation has no bearing on the dispute with the (modern) "productivity theorists." Nobody is so thickheaded as to deny the fact that a higher subjective valuation of a marginal present dollar is necessary and sufficient for a positive rate of interest. What the "productivity theorists" (as well as Böhm-Bawerk) try to explain is *why* this higher valuation of the present dollar exists in the first place, and in this explanation they feel, rightly or wrongly, that technological facts are just as relevant as exogenous features of preferences.

Next is Pellengahr's attempted synthesis, and unfortunately the conclusion is unsatisfactory (pp. 59-61). Indeed, one might read *it* without realizing that it had even been presented. It seems Pellengahr rehabilitates the PTPT by reformulating it merely as the insight that considerations of time are what interest is "essentially" about. Although this is certainly true, the point has already been made by others, particularly Kirzner, and it renders the PTPT largely vacuous.

In closing, Ingo Pellengahr's *The Austrian Subjectivist Theory of Interest* is by far the most lucid account on the subject. In addition to thoroughly clarifying the subtle distinctions in the exposition of the PTPT by various authors, Pellengahr raises some interesting issues. A personal favorite (p. 12) is the tantalizing suggestion that Menger's infamous dismissal of Böhm-Bawerk's *Positive Theory*, as "one of the greatest errors ever committed," was perhaps not due merely to his focus on productivity, but *also* to his notion of discounting future utility–a procedure which at first smacks of cardinality, particularly in the manner used by Böhm-Bawerk. Current advocates of the PTPT would do well to convince themselves of the considerations behind Menger's statement before citing it as proof of the PTPT's superior claim to subjectivism.

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